

# Children and the Income Tax

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## I. INTRODUCTION

All children are not equal under the federal income tax. Under different circumstances, the addition of a dependent child to a taxpayer's household may save the taxpayer in excess of \$2,000 to absolutely nothing. At one extreme, the first child of a low income single parent produces a tax benefit of more than \$2,700.<sup>1</sup> The first child of an unmarried middle income taxpayer is almost as valuable, resulting in tax savings of almost \$2,000. At the other extreme, there is no tax benefit from any child of very high income parents or from third and later children of low income parents. Between these extremes, the typical child of middle income parents produces tax savings ranging from about \$400 to \$700. A dependent child can trigger four tax benefits: the dependency exemption,<sup>2</sup> head of household status,<sup>3</sup> the earned income tax credit ("EITC")<sup>4</sup> and the child care credit.<sup>5</sup> There are different rules concerning the effect of the number of children and of the taxpayer's income level on each benefit.

The enormous variation in the tax consequences attributable to children suggests a need to evaluate how the income tax adjusts for family responsibilities. The issue is timely because there have been

<sup>1</sup> The calculations supporting these examples are explained in text accompanying notes 24-30.

<sup>2</sup> IRC § 151(c).

<sup>3</sup> IRC § 2(b). This status entitles an unmarried person with a dependent child to a larger standard deduction than other single people, IRC § 63(c)(2), and to a more favorable tax rate schedule, IRC § 1(b).

<sup>4</sup> IRC § 32.

<sup>5</sup> IRC § 21.

numerous legislative proposals in recent years<sup>6</sup>—one of which nearly became law<sup>7</sup>—for major changes in the income tax treatment of children. Although the focus has been more on increasing tax benefits to families with children than on rationalizing the distribution of benefits among families, the legislative interest in the subject presents an opportunity to reconsider both the level and the distribution of these benefits.

This Article is a comprehensive review of the various ways the Code might adjust tax liabilities to reflect differences in family responsibilities. It begins with a description of current tax benefits for families, some examples of how those benefits work in different situations and a review of proposals for reform.

## II. CURRENT LAW

### A. *The Four Child Tax Benefits for Children*

The most widely available of the four benefits is the dependency exemption. The exemption functions as a deduction of a flat \$2,500 for each dependent child,<sup>8</sup> regardless of how many children the taxpayer may have. The tax savings from the exemption depend on the taxpayer's marginal rate. For example, one exemption saves \$375 for a taxpayer in the 15% bracket and \$700 for a taxpayer in the 28% bracket. Although the size of the exemption for a child does not depend on the number of other dependents, it is sensitive to the taxpayer's income. Phaseout of the exemption begins at parental adjusted gross income ("AGI") of \$172,050.<sup>9</sup> Eventually, the exemption is phased out entirely, so that dependents entitle very high income parents to no exemptions.

Unlike the dependency exemption, the benefits of which increase proportionately with the number of children, head of household status produces a large benefit for the first child of an unmarried taxpayer, and no additional benefit for more children. A single person with no dependents is entitled to a standard deduction of \$3,900 and is subject

<sup>6</sup> See, e.g., S. 1411, 102d Cong., 1st Sess. (1991).

<sup>7</sup> Tax Fairness and Economic Growth Act of 1992, H.R. 4210, 102d Cong., 2d Sess. (vetoed by President Bush, Mar. 20, 1992).

<sup>8</sup> IRC § 151(d)(1), (4). The amount of the exemption is indexed for inflation, and is \$2,500 for 1995. Rev. Proc. 94-72, 1994-50 I.R.B. 14, 17 (Dec. 12).

<sup>9</sup> IRC § 151(d)(3). The \$172,050 figure is for a married couple filing a joint return. Phaseout begins at \$143,350 for a head of household. A taxpayer loses 2% of all exemptions for each \$2,500 (or fraction thereof) by which AGI exceeds \$172,050 (or \$143,350). The phaseout is complete at \$294,550 for a joint return and \$265,850 for a head of household. The phaseout levels are adjusted for inflation. The levels cited are for 1995. Rev. Proc. 94-72, note 8, at 18.

to an unfavorable tax rate schedule.<sup>10</sup> A single person living with at least one dependent is entitled to a standard deduction of \$5,750 and is subject to a more favorable tax rate schedule.<sup>11</sup> In contrast to the dependency exemption, the benefit of head of household status continues regardless of the taxpayer's income level.<sup>12</sup>

The refundable EITC functions as a wage supplement for low income workers. Until the 1993 amendments,<sup>13</sup> the credit was available only to a worker living with a "qualifying child."<sup>14</sup> A childless worker is now eligible for a maximum credit of \$314.<sup>15</sup> A dependent child makes a dramatic difference, increasing the maximum credit to \$2,094.<sup>16</sup> A second child makes a smaller, but still significant difference: The maximum credit rises to \$3,110.<sup>17</sup> There is no benefit for additional children. Thus, sensitivity of the credit to the number of children differs from both the dependency exemption, which is equally sensitive to all children, and from head of household status, which is sensitive only to the first child. Like the exemption and unlike head of household status, the credit is tied expressly to the taxpayer's income level. The one child credit is fully phased out at \$24,396 AGI, and the two child credit at \$26,673.<sup>18</sup>

The child care credit is the only one of the four child-related tax provisions that depends on amounts actually spent on children. The credit is a percentage—20% for most taxpayers<sup>19</sup>—of the amount spent by a taxpayer on child care "to enable the taxpayer to be gain-

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<sup>10</sup> IRC § 63(c)(2)(C) (standard deduction), § 1(c) (rate schedule); Rev. Proc. 94-72, note 8, at 17 (inflation adjustments).

<sup>11</sup> IRC § 63(c)(2)(B) (standard deduction), § 1(b) (tax rate schedule); Rev. Proc. 94-72, note 8, at 17 (inflation adjustments). The existence of one or more dependents does not affect the standard deduction or tax rate schedule of a married couple.

<sup>12</sup> The benefit of the more favorable rate schedule remains at all income levels. The benefit of the larger standard deduction also continues, but it becomes less important at high income levels because most high income taxpayers itemize rather than claim the standard deduction. See discussion in text accompanying notes 88-100.

<sup>13</sup> Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13131(b), 107 Stat. 312, 433.

<sup>14</sup> IRC § 32(c)(1)(A) (before amendment in 1993).

<sup>15</sup> The credit is 7.65% of the first \$4,100 of earned income, with the credit phased out at 7.65% as AGI exceeds \$5,130. See IRC § 32(b)(1) (credit percentages and phaseout percentages), § 32(b)(2) (earned income amounts and the phaseout amounts); Rev. Proc. 94-72, note 8, at 16 (inflation adjustments for 1995).

<sup>16</sup> The credit is 34% of the first \$6,160 of earned income. A 15.98% phase out begins at \$11,290 AGI. IRC § 32(b); Rev. Proc. 94-72, note 8, at 16.

<sup>17</sup> The credit is 36% (40% for years beginning after 1995) of the first \$8,640 of earned income. A 20.22% (21.06% for years beginning after 1995) phaseout begins at \$11,290 AGI. IRC § 32(b); Rev. Proc. 94-72, note 8, at 16.

<sup>18</sup> IRC § 32(b)(2); Rev. Proc. 94-72, note 8, at 16.

<sup>19</sup> The credit rate is 30% for taxpayers with AGI of \$10,000 or less, declining gradually until it becomes 20% for taxpayers with AGI of more than \$28,000. IRC § 21(a)(2).

fully employed.”<sup>20</sup> The ceiling on expenses eligible for the credit is \$2,400 if there is one eligible child, and \$4,800 if there are two or more.<sup>21</sup>

### B. *The Tax Benefits of Children—Some Examples*

A few examples will dramatize the radical difference in the tax consequences of dependent children, depending on the taxpayer's income, marital status and total number of dependents.

*Middle Income Married Couple.* Perhaps the most common situation is the middle income married couple, whose income is too high for the EITC and too low for the phaseout of exemptions. The only tax benefit the couple receives for a child, not based on actual expenditures on the child, is a \$2,500 exemption, which will save them either \$375 (15% bracket) or \$700 (28% bracket) in taxes.<sup>22</sup> Each child produces the same benefit regardless of the number of children in the family. If the parents spend money on child care, they may obtain a maximum additional benefit of \$480 (20% of \$2,400)<sup>23</sup> for each of the first two children, but nothing for any additional children.

*Middle Income Single Person.* This taxpayer receives a much larger benefit for the first child. Consider a single person whose only income is \$40,000 in wages, and who does not itemize deductions. Without a child, that person owes \$6,372.50 in income tax.<sup>24</sup> With the addition of a child, the combined effects of the dependency exemption and head of household status reduce the tax liability to \$4,485—a savings of \$1,887.50.<sup>25</sup> If the taxpayer spends at least \$2,400 on child care, there will be an additional \$480 tax savings. A second child, by contrast, has no effect on head of household status and produces only the modest tax savings described above for middle income couples.

<sup>20</sup> IRC § 21(b)(2)(A).

<sup>21</sup> IRC § 21(c). A different tax benefit for child care is provided by § 129, which excludes from income (the equivalent of inclusion and deduction) child care provided by an employer pursuant to a dependent care assistance program. This provision is even less sensitive to family size than the child care credit. The maximum amount excludable is \$5,000, without regard to the number of children. IRC § 129(a)(2)(A).

<sup>22</sup> See note 8.

<sup>23</sup> IRC § 21.

<sup>24</sup> Subtracting the taxpayer's personal exemption of \$2,500 and the single person standard deduction of \$3,900 leaves taxable income of \$33,600. At § 1(c) rates, there is a tax liability of \$6,372.50. Rev. Proc. 94-72, note 8, at 15.

<sup>25</sup> The standard deduction rises by \$1,850, to \$5,750, IRC § 63(c)(2)(B); Rev. Proc. 94-72, note 8, at 17, and there is a \$2,500 dependency exemption. In addition, the 15% bracket for head of household status covers the first \$31,250 of taxable income, compared with only \$23,350 for a childless single taxpayer. IRC § 1(b); Rev. Proc. 94-72, note 8, at 15.

*Low Income Single Taxpayer.* Even more impressive are the tax consequences of a child to a single person with wage income of \$11,000. Without a child, the person's tax liability is \$690.<sup>26</sup> With a child, the person is entitled to a *refund* of \$2,041.50<sup>27</sup>—a difference of \$2,731.50. Of that difference, \$2,094 is due to the EITC and the rest to head of household status and the personal exemption. If the person had child care expenses, the difference would be even greater. A second child increases the refund to \$3,110.40, an additional benefit of \$1,068.90.<sup>28</sup> All but \$52.50 of this increase is due to the EITC. Head of household status is unaffected by the second child, and the additional exemption can offset only the \$350 of taxable income left after the first child, producing only a \$52.50 benefit. The rest of the exemption (\$2,150) is wasted. The addition of a third child produces no additional tax benefit. The additional exemption is useless because there is no remaining income to offset, and the EITC does not increase when there are more than two children. The contrast in the tax treatment of the first and third children of the same taxpayer is astonishing.

*Very High Income Taxpayer.* The failure of the tax system to adjust for dependents reappears at very high income levels. A married couple with \$300,000 income is entitled to no child-related tax benefits except the child care credit. The dependency exemption is fully phased out—regardless of how many or few children there may be—at \$294,550.<sup>29</sup> If there are no child care expenses, because one parent is a full-time homemaker, the couple will pay the same tax with one, two or a dozen children, as they would have paid with none.<sup>30</sup>

<sup>26</sup> Taxable income is \$4,600 (\$11,000 gross income reduced by a \$2,500 personal exemption and a \$3,900 standard deduction). IRC § 151(d)(1), (4) (exemption), § 63(c)(2)(C) (standard deduction); Rev. Proc. 94-72, note 8, at 17. At the applicable 15% rate, the tax is \$690. IRC § 1(c); Rev. Proc. 94-72, note 8, at 15. Because the EITC for a childless taxpayer is fully phased out at \$9,230 AGI, there is no EITC. IRC § 32(b)(2); Rev. Proc. 94-72, note 8, at 16.

<sup>27</sup> The \$2,500 dependency exemption and the additional \$1,850 standard deduction, IRC § 63(c)(2)(B); Rev. Proc. 94-72, note 8, at 17, reduce taxable income to \$350, resulting in a 15% tax liability (precredit) of \$52.50. IRC § 1(b); Rev. Proc. 94-72, note 8, at 17. The EITC is \$2,094 (34% of \$6,000). Phaseout of the credit does not begin until AGI exceeds \$11,290. IRC § 32(b); Rev. Proc. 94-72, note 8, at 16.

<sup>28</sup> The second exemption eliminates the remaining \$350 of taxable income, resulting in no precredit tax liability. The 36% EITC on \$8,640 of earned income is \$3,110.40—an increase of \$1,016.40 over the one child credit. IRC § 32(b); Rev. Proc. 94-72, note 8, at 16.

<sup>29</sup> IRC § 151(d)(3); Rev. Proc. 94-72, note 8, at 18.

<sup>30</sup> Even if there are child care expenses, the ceiling on eligible expenditures does not increase when there are more than two children. IRC § 21(c).

*C. Previous Proposals for Change*

Although proposals for change in the tax consequences of children have been numerous, they fall into a few general categories. The simplest proposals are for substantial increases in the size of the dependency exemption.<sup>31</sup> A variation on this theme is to increase the standard deduction for larger families. One proposal would increase the standard deduction by \$1,400 for each dependent.<sup>32</sup> The difference between the two approaches is in their effects on higher income taxpayers. Increased exemptions are subject to any phaseout rule that applies to exemptions. Increased standard deductions are not formally phased out, but only taxpayers who do not itemize deductions receive their benefits, and nonitemizers are uncommon at higher incomes.

Another set of proposals would eliminate the dependency exemption and replace it with a flat dependency credit of, for example, \$800<sup>33</sup> or \$1,000<sup>34</sup> per child.<sup>35</sup> Unlike a flat exemption amount, which produces the largest tax savings for the highest bracket taxpayers, a flat credit produces equal savings for all taxpayers, regardless of income level.

Some proposals have combined exemptions and credits, by adding credits onto the existing exemptions. One of these proposals was passed by both the House and the Senate in 1992, but failed to become law when President Bush refused to sign it.<sup>36</sup> The legislation would have added a nonrefundable inflation-indexed \$300 credit for each child under the age of 16, which would have been phased out over the AGI range of \$50,000 to \$70,000.<sup>37</sup> More recently, the House

<sup>31</sup> Bills introduced include: H.R. 436, 103d Cong., 1st Sess. (1993) (proposing increase to \$3,500); H.R. 2714, 102d Cong., 1st Sess. (1991) (proposing increase to \$4,000); S. 152, 102d Cong., 1st Sess. (1991) (proposing increase to \$4,000); S. 1411, 102d Cong., 1st Sess. (1991) (proposing increase by approximately 50% for 15% bracket taxpayers and by approximately 25% for 28% bracket taxpayers).

<sup>32</sup> H.R. 3202, 102d Cong., 1st Sess. (1991).

<sup>33</sup> Working Family Tax Relief Act of 1991, H.R. 2242, 102d Cong., 1st Sess. § 101(a).

<sup>34</sup> National Commission on Children, *Beyond Rhetoric: A New American Agenda for Children and Families* 80 (1991) [hereinafter *Beyond Rhetoric*]; C. Eugene Steuerle & Jason Juffras, *A \$1,000 Credit for Every Child: A Base of Reform for the Nation's Tax, Welfare, and Health Systems* (1991).

<sup>35</sup> A joint proposal of the Family Research Council and the Heritage Foundation would replace the dependency exemption with a credit of \$1,800 for a preschool age child and \$1,200 for an older child. *Reclaiming the Tax Code for American Families: Hearings Before the House Select Comm. on Children, Youth, and Families*, 102d Cong., 1st Sess. 59 (1991) [hereinafter *Reclaiming the Tax Code*] (statement of Gary L. Bauer, President, Family Research Council) [hereinafter *Bauer Statement*].

<sup>36</sup> H.R. 4210, note 7, § 1001(a)-(c); see H.R. Rep. No. 461, 102d Cong., 2d Sess. 312-13 (1992) (explaining the proposal).

<sup>37</sup> *Id.* There have been other proposals to add a credit to the existing exemption. President Clinton made the rather strange suggestion of adding a \$300 per child credit for lower

Republicans' 1994 "Contract with America" has included a \$500 per child add-on credit, available to all families with incomes up to \$200,000.<sup>38</sup>

Still other proposals have focused on preschoolers, either by granting a larger exemption for them than for older children,<sup>39</sup> or by providing a special credit only for younger children.<sup>40</sup> Such special benefits function like ordinary dependency exemptions or credits in that they do not depend on proof of actual expenditures on children. Rhetorically, however, their advocates often look to the child care credit, rather than general dependency allowances, to make their case for special preschool credits or exemptions. Their argument is that the expenditure-based child care credit discriminates against stay-at-home mothers, who do not qualify for the credit because they incur no out-of-pocket child care expenses.<sup>41</sup>

Significant additional tax relief for families with children would be expensive, and that is a serious obstacle in an era of revenue-driven tax legislation. The prospect for relief still seems good, however, because of an emerging conservative-liberal consensus in its favor. Conservatives see child tax relief as an important part of their pro-family agenda, while liberals have come to support relief partly out of a feminist concern for working mothers and partly to avoid conservative charges of being antifamily.<sup>42</sup> The most significant tax legislation in a generation—the Tax Reform Act of 1986<sup>43</sup>—grew out of an unusual

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and middle income taxpayers, with the credit available for all children *except* the first child in a family. Bush's Tax Attack: Get the Facts, Says Clinton Campaign, Oct. 2, 1992, available in LEXIS, News Library, USNWR File. The Heritage Foundation has advocated a \$500 per child nonrefundable credit. Heritage Foundation, Putting Families First: A Deficit Reduction and Tax Relief Strategy 3 (Background Paper No. 927, 1993).

<sup>38</sup> American Dream Restoration Act, H.R. 6, 104th Cong., 1st Sess. § 2(a) (1995). The credit is phased out for AGI between \$200,000 and \$250,000 and both the credit amount and phaseout AGI amounts are indexed for inflation.

<sup>39</sup> S. 1875, 102d Cong., 1st Sess. (1991) (increasing dependency exemption, depending on the taxpayer's bracket, to a maximum of \$7,000 for children younger than six, with the exemption gradually decreasing to the current level for children ages six to 10); Elaine C. Kamarck & William A. Galston, Progressive Policy Institute, Putting Children First: A Progressive Family Policy for the 1990's, at 24 (1990) (proposing to raise the personal exemption for a child under age four to \$6,000 with the excess of this amount over the normal dependency exemption phased out in the upper middle class income range).

<sup>40</sup> Reclaiming the Tax Code, note 35, at 59 (describing Heritage Foundation proposal to replace the dependency exemption *and* the child care credit with a credit of \$1,800 for preschoolers and only \$1,200 for older children).

<sup>41</sup> Bauer Statement, note 35, at 54-56.

<sup>42</sup> In a 1991 hearing on families and the income tax, Representative Frank Wolf aptly commented that one could have ripped the cover off the report on families and taxes of the liberal Progressive Policy Institute and it would have passed for a report of the conservative Heritage Foundation. Reclaiming the Tax Code, note 35, at 121.

<sup>43</sup> Pub. L. No. 99-514, 100 Stat. 2085.



conservative-liberal consensus,<sup>44</sup> and child tax relief will likely do the same.

#### *D. A Look Ahead*

The remainder of the Article is a critical analysis of the various ways the income tax might take into account dependent children. My aim is not so much to argue for any particular approach, as it is to explain the theoretical underpinnings and practical effects of each approach. Armed with that understanding, readers may reach their own conclusions. This does not prevent me, however, from offering my own opinions of the relative merits of the various approaches.

An argument for income tax recognition of family responsibilities may be either tax-internal or tax-external.<sup>45</sup> The basic tax-internal argument is that income tax liabilities should vary with ability to pay, that family responsibilities affect ability to pay, and that the tax law therefore should take dependent children into account. A tax-external argument does not depend on the income tax goal of adjusting tax burdens according to ability to pay, but on the usefulness of the tax laws in promoting some nontax objective—such as subsidizing parental care of children because of the benefits to society of well-reared children (or the detriment of badly-reared children). In other words, the tax benefits for families with children is justified as a tax expenditure.<sup>46</sup>

The Article first considers the (always unpopular) argument against any ability to pay allowance for children—that children represent a consumption choice by their parents, and that money voluntarily spent on children voluntarily acquired deserves no more tax recognition than money voluntarily spent on a vacation or an expensive car. Next, the Article examines the classic case for the traditional child allowance of the U.S. income tax<sup>47</sup>—the dependency exemption. The

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<sup>44</sup> The basic approach of the 1986 Act was to lower tax rates without losing revenue by broadening the tax base at the same time. Conservatives liked the lower rates while liberal tax reformers liked closing loopholes. C. Eugene Steuerle, *The Tax Decade: How Taxes Came to Dominate the Public Agenda* 5-11 (1991).

<sup>45</sup> Michael J. McIntyre, *A Solution to the Problem of Defining a Tax Expenditure*, 14 U.C. Davis L. Rev. 79, 94-96 (1980) (making this point and noting that a dependency exemption is defended best by a tax-internal analysis, whereas a dependency credit is supported best by a subsidy (tax expenditure) analysis).

<sup>46</sup> The concept of tax expenditures—subsidies designed to serve nontax goals, but embedded in the tax laws—was developed and popularized by Stanley Surrey. See, e.g., Stanley S. Surrey & Paul R. McDaniell, *Tax Expenditures* (1985).

<sup>47</sup> The continuing exemption is the traditional approach of the U.S. income tax, but it is not precisely the current approach. Under current law (introduced in 1986 and made permanent in 1993), personal exemptions are phased out at very high income levels. IRC § 151(d)(3).

case rests on the proposition that a fair income tax must fall only on "clear" or discretionary income—income above that needed to sustain life at a subsistence level. An important issue under this clear income analysis is whether the exemption of subsistence level income should apply at all income levels, or whether it should be phased out at some point. Closely related to that question is whether the tax allowance for family size should be converted to adjustments in the amount of the standard deduction, which would amount to a de facto phasing out of the adjustments at higher incomes.

The Article then considers whether family size adjustments should reflect the differing expenditures on children by families at different income levels, rather than only the costs of maintaining children at subsistence. Under this approach—often referred to as income splitting—the amount of family income spent on each child would be taxed to that child, rather than to the parents.

Practical application of any of these tax-internal family size adjustments requires information on the actual costs of (or expenditures on) children, including how those costs vary with family income level, and with the number and age of children. Proponents of child tax benefit reform often overlook the importance of this information. The Article reviews in detail the literature on this issue, and considers the implications for the design of tax rules.

The Article turns then to the tax-external arguments for child tax allowances. The basic case for this tax expenditure is simple: Families with children are worthy of a federal subsidy because of the positive externalities of well-cared-for children and the negative externalities of poorly-cared-for ones. There is universal agreement that if a subsidy is the goal, credits are more suitable than exemptions, because of the upside-down nature of a subsidy designed as an exemption—an exemption of a fixed dollar amount gives the largest benefit to the highest bracket taxpayer, whose need is least. There is no agreement, however, on the details of designing a child tax credit. Among the important issues are: the amount of the credit, including whether the amount should vary by age or number of children; whether the credit should be refundable if it exceeds tax liability (in which case, it is arguably not really a part of the tax system at all); whether the credit should be phased out at some higher income level; whether the credit should be taxable, instead of or in addition to being phased out; and whether it makes logical (as opposed to political) sense to have both a credit and an exemption.

Another tax-external argument relating to the treatment of family responsibilities is that the tax law should be used as an instrument of population policy. Depending on one's view of population trends and

desirable population levels, one may want either a tax expenditure to encourage fertility or a tax penalty (reverse tax expenditure) to discourage fertility. Both arguments have been made in the United States in the last few decades. The Article reviews the arguments, including the evidence on fertility trends and the practical problems of using tax rules to influence population.

The Article concludes by extending its analysis beyond the basic child tax allowance (whether exemption or credit), to a consideration of the other important, but less general, tax benefits afforded to some families with children: head of household status, the child care credit and the earned income tax credit.

### III. THE TAX-INTERNAL ANALYSIS

#### A. *Children as Consumption*

Henry Simons, perhaps the leading American tax theorist of the 20th century, was of the opinion that money spent on children was a voluntary consumption expenditure of their parents.<sup>48</sup> From this, it would seem to follow that money spent on children should have no more relevance to parental ability to pay income tax than money spent on vacations or sports cars.<sup>49</sup> This view cannot be dismissed summarily. Certainly, many parents choose to have children, and derive at least as much pleasure from expenditures on their children as they would from equal expenditures on trips or cars.<sup>50</sup>

There are arguments against Simons' position from both the parents' and the child's perspective. From the parents' perspective, the initial decision to have a child is not necessarily voluntary—unless one is willing to say that those who do not want children should be celibate, discover a foolproof method of birth control or have an abortion.<sup>51</sup> If one declines to assume that the acquisition of a child is voluntary, then there is a strong argument that money the parent is

<sup>48</sup> Henry C. Simons, *Personal Income Taxation* 140 (1938).

<sup>49</sup> Simons himself was not quite that doctrinaire: "[I]t would be hard to maintain that the raising of children is not a form of consumption on the part of the parents—whether one believes in the subsidizing of such consumption or not." *Id.* at 140.

<sup>50</sup> Edward P. Lazear and Robert T. Michael hypothesize two married couples, each of which spends the same amount of money on adults. One couple is childless; the other has children on whom additional money is spent. They suggest it is reasonable to view the second couple as being better off. "After all, children are not distributed randomly but are found in households that like having children. The satisfaction of having the children *per se* should be considered [in determining the relative welfares of the two couples]." Edward P. Lazear & Robert T. Michael, *Allocation of Income Within the Household* 193 (1988).

<sup>51</sup> Boris Bittker notes that even those who reject a child dependency exemption on the grounds that having a child is a consumption choice, should accept a dependency exemption for a taxpayer legally obligated to support a dependent *parent*. Boris I. Bittker, *Federal Income Taxation and the Family*, 27 *Stan. L. Rev.* 1389, 1446 (1975).

legally obligated to spend on support of the child is not voluntary consumption. Even if the acquisition of the child is voluntary, the child's existence gives rise to a continuing legal obligation of support that cannot easily be escaped if one later changes one's mind (in the way, for example, that one can readily escape the high insurance costs of a sports car by selling the car). Thus, the continuing obligation of support reasonably can be viewed as involuntary even if having the child was voluntary. The scope of the parental support obligation is not always well defined—is the obligation limited to subsistence or does it increase with the parent's means?<sup>52</sup>—but its existence makes a taxpayer's legal relationship to his child radically different from his relationship to his sports car.<sup>53</sup>

The other argument against children as consumption takes the child's point of view, and has been expressed well by Jane Gravelle: "The troublesome aspect of this treatment of children as consumption is that it considers only the well-being of the parent . . . . This approach does not, however, consider the well-being of children, treating them as objects rather than individuals."<sup>54</sup> The rhetoric is powerful, but in reality, Simons' approach neither denies the personhood nor ignores the welfare of children. Because the question is the relevance of dependent children to the taxpaying ability of the parent, it does not deny the children's humanity for the consumption analysis to focus on the parent.<sup>55</sup> More practically, the child welfare argument fails because of the very weak link between any child tax allowance granted to the parent and the welfare of the child. The tax

<sup>52</sup> It is clear that a noncustodial parent is required to provide support for his children according to his means, so that he may be liable for much more than the child's subsistence needs. Unif. Marriage and Divorce Act § 309, 9A U.L.A. 400 (1987); *White v. Marciano*, 235 Cal. Rptr. 779 (1987); John D. Gregory, Peter N. Swisher & Sheryl L. Scheible, *Understanding Family Law* 262-67 (1993). The law is less clear regarding the scope of the support obligation in an intact family. Courts seldom interfere with the standard of support provided, except in the most extreme cases. On the other hand, the common law doctrine of necessities has long permitted a spouse or child to purchase necessities on the credit of the other spouse or parent, with the scope of the doctrine determined by available financial resources. *Id.* at 67.

<sup>53</sup> One could accept the argument that amounts the parent is legally obligated to spend on the child should not be taxed *to the parent*, but still contend that those amounts should be taxed *to the child*. Advocates of clear income analysis would respond that even if the tax system treats money spent on the child as the child's income, it should be tax free to the extent it is needed for subsistence. See text accompanying note 117. The argument for taxing the child is much stronger for amounts spent on the child in excess of subsistence.

<sup>54</sup> Jane G. Gravelle, *Federal Income Tax Treatment of the Family* 12 (Congressional Research Serv. 1991). The same argument is made, in equally strong terms, in John T. Noonan & Cynthia Dunlap, *Unintended Consequences: Laws Indirectly Affecting Population Growth in the United States*, in VI Research Reports, *Aspects of Population Growth Policy* 115, 123 (Robert Parke, Jr. & Charles F. Westhoff eds., 1972).

<sup>55</sup> A child-centered argument, however, does work well to explain why money spent on the subsistence needs of the child should not be taxed *to the child*. See note 53.

allowances at issue are not based on proof of any actual parental expenditures for the benefit of a child, so the allowances neither require nor encourage the parent to spend on the child. The child probably would share in the tax savings from the child tax allowance to the same extent the child benefits from any other increase in family net income. To illustrate, one recent study concluded that families tend to share income by spending about \$40 on each child for every \$100 spent on each adult.<sup>56</sup> Thus, in a two-adult, one-child household, a child could expect to receive less than 20% of the tax savings created by a child tax allowance—about \$40 for every \$240 of tax savings. The weakness of the link between the child tax allowance and the well being of the child exposes the emptiness of the rhetoric of the child-centered argument. Even if the allowance *were* based on actual expenditures, the argument would be weak with respect to children of high income parents, whose well being is not even remotely at the mercy of the income tax treatment of family responsibilities.

Despite the infirmity of the child-centered argument, the parent-centered argument against children as consumption remains strong. As Boris Bittker has remarked, “no one but a tax theorist . . . could fail to see the difference” between the cost of supporting a child and the cost of maintaining a yacht.<sup>57</sup> Whatever may be said in theory for the view of children as consumption, there is no political or popular support in the United States today for an income tax generally treating children as just another consumption choice, irrelevant to the determination of tax liability.<sup>58</sup>

## *B. The Clear Income Argument for a Subsistence-Level Exemption*

### *1. The Basic Argument*

The classic defense of a dependency exemption available to taxpayers regardless of income level is based on the concept of clear (or discretionary) income.<sup>59</sup> Under this analysis, a person has no ability

<sup>56</sup> Lazear & Michael, note 50, at 6.

<sup>57</sup> Bittker, note 51, at 1448.

<sup>58</sup> The “generally” is necessary because the effect of the phaseout of personal exemptions is to make children irrelevant to tax liability for very high income parents. IRC § 151(d)(3) (discussed in text accompanying notes 8-9).

<sup>59</sup> The best elaboration of the case is Gerard M. Brannon & Elliott R. Morss, *The Tax Allowance for Dependents: Deductions Versus Credits*, 26 Nat'l Tax J. 599 (1973). An earlier statement of the argument is in Harold M. Groves, *Federal Tax Treatment of the Family* 10 (1963). There is also a less principled defense of flat dependency exemptions as a compromise between those who believe the size of exemptions should increase as income increases and those who believe no exemptions should be allowed at higher income levels. *Id.* at 35. Exemptions increasing with income are discussed in text accompanying note 117, and vanishing exemptions are discussed in text accompanying notes 74-87.

to pay tax on income necessary to support basic subsistence. Ability to pay comes only from clear income—that is, income in excess of subsistence needs. This justifies both the taxpayer's own personal exemption (and standard deduction), and additional exemptions for each family member—because the larger the family, the larger the income needed for subsistence. Under this view, the function of the dependency exemptions is not only, or even primarily, to exempt families at or below poverty level from tax,<sup>60</sup> but to differentiate the tax liabilities of families above the poverty level based on the effect of family size on ability to pay.<sup>61</sup>

For example, if the subsistence cost of a child is \$2,500, then a childless couple with \$40,000 income and a couple with one child and \$42,500 income have equal amounts of clear income and should pay equal taxes.<sup>62</sup> This is *not* based on the assumption that the second couple spends only \$2,500 on the child. In all likelihood, the parents spend considerably more. Under the clear income analysis, however, only the \$2,500 needed for the child's subsistence is relevant for tax purposes. There are two ways of explaining why additional amounts spent on the child should have no tax consequences. First, under the basic income tax principle that income should be taxed to the person in control of the income rather than the person who consumes the income, the parents should avoid tax only on the income they do not really control because they are legally obligated to spend it on the child's basic needs.<sup>63</sup> If they *choose* to spend more than that on the

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<sup>60</sup> See Deborah H. Schenk, *Simplifying Dependency Exemptions: A Proposal for Reform*, 35 Tax Law. 855, 866-68 (1982) (justifying dependency exemption on this ground). Not imposing any income tax on families at or below the official poverty level was a stated goal of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. S. Rep. No. 313, 99th Cong., 2d Sess. 31-33, reprinted in 1986-3 C.B. (vol. 3) 31-33. As unobjectionable as that goal may seem, it has been criticized on the ground that one's status as a taxpayer—regardless of income level—has important symbolic value in a democracy. See Groves, note 59, at 25.

<sup>61</sup> If the goal were to exempt poverty level income from tax *without* family size differentiation above that level, the proper approach would be a lump sum exemption available only to taxpayers with incomes at or below the poverty level. The United Kingdom used a system of this sort from 1806 to 1909. A notch adjustment was used to prevent those with incomes slightly above the poverty level from being taxed into poverty. This adjustment prevented the marginal tax rate just above the exemption limit from ever exceeding 100%. Lawrence H. Seltzer, *The Personal Exemptions in the Income Tax* 130-31 (1968).

<sup>62</sup> The clear income of each couple is something less than \$40,000 because of the subsistence needs of the adults.

<sup>63</sup> *Helvering v. Horst*, 311 U.S. 112 (1940) (discussing the control principle's application to income from coupon bonds and property, more generally); *Lucas v. Earl*, 281 U.S. 111 (1930) (discussing the control principle's application to earned income from services). The control principle also is discussed in Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. Cal. L. Rev. 339, 354-58 (1994) [hereinafter *Marriage*].

child, they are in control of that expenditure, and should be taxed.<sup>64</sup> The second explanation is that the parents are not merely in *control* of discretionary spending on the child, but that they also *consume* such spending. The claim is that amounts spent on the child above subsistence are viewed properly as discretionary consumption by the parents, who derive pleasure of their own from the expenditure.<sup>65</sup>

The clear income approach does not distinguish between families with the same amount of clear income based on how many family members share the clear income. In the example, the two member family and the three member family have the same clear income, and thus the same tax liability, despite the fact that the clear income must be divided among three people in one family and between only two in the other.<sup>66</sup> This result is appropriate under the control principle—the parents are the taxpayers and they are in control of the same amount of income in both cases. The result is also appropriate if the parents are considered the true consumers of discretionary spending on the child. The result nevertheless is controversial and is the crux of the dispute between the clear income school and proponents of income splitting within families.<sup>67</sup>

The standard criticism of dependency exemptions, by advocates of credits, is that flat exemptions inappropriately give the largest child subsidies to the highest bracket taxpayers, who need help least.<sup>68</sup> For

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Under an extremely rigorous application of the control principle, the parent might not escape taxation on even the \$2,500, because the parent controlled the source of that income (the parent's labor). For further discussion of this point, see note 109.

<sup>64</sup> Arguably, however, family law does not distinguish this neatly between necessities and luxuries in defining the scope of the parental obligation of support. See note 52 and accompanying text.

<sup>65</sup> Rigorously pursued, the logic of this argument suggests that both the parents and the child are able to consume discretionary spending on the child and both should be taxed. See Bittker, note 51, at 1445-47 (discussing the dependents as "consumption" theory). Of course, the child forced to take piano lessons over his strenuous objections has a plausible claim that *he* has not consumed the cost of the lessons.

<sup>66</sup> Gerard Brannon has acknowledged and defended this result: "[I] do not think it is society's particular concern to change the tax treatment of [above-poverty] income because the family decides to divide it among more people or fewer people." Gerard Brannon, Commentary, in *Taxing the Family* 104, 105 (Rudolph G. Penner ed., 1983) [hereinafter *Taxing the Family*].

<sup>67</sup> For a discussion of family income splitting, see text accompanying notes 101-27.

<sup>68</sup> Examples of this criticism are abundant. See, e.g., Harvey E. Brazer, *The Federal Income Tax and the Poor: Where Do We Go From Here?*, 57 Cal. L. Rev. 422, 441 (1969) (noting that the tax saving attributable to an exemption for dependent children is greatest for the highest bracket taxpayers); Sheila B. Kamerman & Alfred J. Kahn, *Social Policy and Children in the United States and Europe*, in *The Vulnerable* 351, 357 (John L. Palmer, Timothy Smeeding & Barbara Boyle Torrey eds., 1988) (discussing how the U.S. family tax allowance helps only families with incomes above the tax threshold and how this help increases as incomes increase); Adil Sayeed, *Choosing Between Tax Credits and Exemptions for Dependent Children*, 33 Can. Tax J. 975, 979 (1985) (reporting on the "child tax credit versus exemption" deduction in the Canadian context and a federal Consultation

example, a \$2,500 exemption saves a high income (36% bracket) taxpayer \$900, but saves a low income (15% bracket) taxpayer only \$375. The response is simple. This criticism of exemptions as upside-down subsidies would be devastating, *if* exemptions were intended as subsidies. The clear income justification for exemptions, however, is based entirely on refinement of the concept of ability to pay. If a taxpayer with a child has \$2,500 less ability to pay than an otherwise identical childless taxpayer, an exemption is the only proper way to reflect that difference. Thus, it is not a subsidy.<sup>69</sup>

Under the clear income analysis, exemptions are not designed to address vertical equity (fairness between taxpayers at different income levels), but horizontal equity (fairness between taxpayers at the same income level, but with different family responsibilities). Exemptions have nothing to do with the relative tax burdens of a person with \$50,000 income and a person with \$100,000 income; exemptions have everything to do with the relative tax burdens of a childless couple with \$100,000 income and a five person family with \$100,000 income.<sup>70</sup>

It is true that replacing a dependency exemption with a flat credit producing equal total revenue loss would increase the progressivity of the tax, as the credit would be less than the tax savings from an exemption at high incomes and more than the savings from an exemption at low incomes.<sup>71</sup> But the increase in progressivity is a function of

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Paper that argued that the child exemption is regressive since the largest benefits go to parents in the top marginal tax bracket while families that are too poor to be paying income tax receive no benefit from an exemption); 3 Report of the Royal Commission on Taxation, *Taxation of Income* 185 (1966) (stating that the greater tax savings to higher bracket taxpayers can be justified "[o]nly if it is assumed that the responsibilities of raising children are less onerous for low income families than for higher income families").

<sup>69</sup> The staff of the Joint Committee on Taxation apparently agrees, since it does not treat the dependency exemption as an item in the tax expenditure budget. Staff of the Joint Comm. on Tax'n, 103d Cong., 1st Sess., *Estimates of Federal Tax Expenditures for Fiscal Years 1995-1999*, at 3 (Comm. Print 1994).

<sup>70</sup> Using exemptions to distinguish between the taxpaying abilities of families of different sizes would be appropriate even if everyone in the country married and had two children. Families still would be of different sizes (and thus different taxpaying abilities) because, at any given time, they would be at different stages of the life cycle. Just-married and elderly couples would have no dependents, and other couples would not have acquired their second dependent or would have lost their first to adulthood. Even in this world of unreal uniformity, dependency exemptions would adjust for differing abilities to pay at different times of life. See Eugene Steuerle, *The Tax Treatment of Households of Different Size*, in *Taxing the Family*, note 66, at 86 [hereinafter *Households*] (discussing the life-cycle distribution of tax burdens); *Tax Policy: What Do Families Need?* Hearings Before the House Select Comm. on Children, Youth, and Families, 99th Cong., 1st Sess. 50, 50 (1985) (statement of Professor Alvin Schorr, Case Western Reserve University) [hereinafter *Tax Policy Hearings*] (noting that increased child tax allowances could respond to the problem "that family need is out of synchronization with family income").

<sup>71</sup> This does not mean, however, that exemptions are regressive. In fact, an income tax with flat exemptions is more progressive than it would be without exemptions (although less progressive than if the exemptions were converted to credits). Exemptions contribute



family size—a large increase for large families and no increase for taxpayers without dependents. Clear income proponents argue persuasively that dependency allowances and progressivity are treated better as separate issues. An income tax can have dependency exemptions and any desired degree of progressivity simply by separating the choice of rates from the exemption issue. First, set income tax rates for a family of some typical size (such as three or four members) so that tax burdens vary appropriately by income levels, making the rates as progressive as desired. Then, set dependency exemptions at the size appropriate to reflect differences in the clear income available to families of equal incomes but different sizes.<sup>72</sup> Some who advocate switching from exemptions to credits on progressivity grounds may not understand this point. Others may understand perfectly well, but may have increasing progressivity in any way possible as their overriding goal, and may believe that a switch to credits is politically more likely than an increase in rate progressivity.<sup>73</sup>

to progressivity because an exemption represents a decreasing percentage of income as income increases. See Groves, note 59, at 8-9 (discussing the effect of exemptions on the progressivity of the system). Groves explains that the effect of exemptions on progressivity can be analyzed by supposing the revenue lost from the exemptions is made up with a tax, such as a simple surtax, that is as progressive as the original tax. *Id.* at 8 n.12. Consider the following example. (For ease of illustration, the example considers the effect of a taxpayer's own personal exemption, rather than a dependency exemption, but the principle is the same.) Imagine an income tax with the following brackets:

<i>Taxable Income</i>	<i>Tax Rate</i>
0 - \$10,000	10%
> \$10,000 - \$30,000	20%
> \$30,000	30%

There are two taxpayers, *A* with \$10,000 income, and *B* with \$50,000 income. If the system allows no personal exemption, *A* would pay \$1,000 tax, which is 10% of her income, and *B* would pay \$11,000, which is 22% of her income. If a \$2,000 personal exemption were introduced while changing nothing else, *A* would pay \$800 tax (8%) and *B* would pay \$10,400 (20.8%). The lost revenue is \$800: \$200 from *A* and \$600 from *B*. Finally, assume the government decides to make up the lost revenue by imposing a surtax as progressive as the original tax. This means that, as with the original tax, *B* should pay 11/12 (\$11,000/\$12,000) of the surtax. Accordingly, *A*'s surtax would be 1/12 (\$800) = \$66.67, and *B*'s would be 11/12 (\$800) = \$733.33. Taking into account both the exemption and the surtax, *A* would pay a total tax of \$866.67, which is \$133.33 less than under the tax without an exemption; *B* would pay a total tax of \$11,133.33, which is \$133.33 more than under the first system. Thus, the exemption would increase the progressivity of the system, notwithstanding that it appears to be more valuable to the higher bracket taxpayer. *B* would receive 3/4 of the tax savings from the exemptions (\$600/\$800), but he would more than pay for that by bearing 11/12 of the burden of the surtax.

<sup>72</sup> See Treasury Dep't, Blueprints for Basic Tax Reform 96-97 (1984) (discussing the use of exemptions versus credits in adjusting for family size); Brannon & Morss, note 59, at 600-01 (explaining that the point at issue in the deduction versus credit argument is the appropriate differentiation between taxpayers having different size families at given income levels, and not how taxpayers at different income levels should be treated).

<sup>73</sup> See The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Comm. on Ways and Means, 95th Cong., 2d Sess. 3558, 3564 (1978) (testimony of

## 2. *The Vanishing Exemption*

It seems to follow from the clear income analysis that dependency exemptions should apply at all income levels.<sup>74</sup> The purpose of the exemptions is not only—or even primarily—to protect persons at or below the poverty line from tax, but to adjust ability to pay for family size at *all* income levels. Even at the \$1 million level, a taxpayer with many dependents has less ability to pay than a taxpayer with no dependents. The U.S. income tax, however, now phases out personal exemptions (both dependency exemptions and the taxpayer's own exemption<sup>75</sup>) at very high income levels.<sup>76</sup> Thus, for example, there is no difference in tax liability between a two person family with \$300,000 income and a five person family with the same income. This result has been criticized,<sup>77</sup> and even called "bizarre."<sup>78</sup>

In addition to eliminating family size distinctions, once it is completed, the phaseout also has the odd effect of imposing differing marginal rates on taxpayers according to the size of their families. A taxpayer loses 2% of each exemption for every \$2,500 by which AGI

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Sheldon Danziger and Jonathan R. Kesselman, School of Social Work and Institute for Research of Poverty, University of Wisconsin-Madison, and Economics Dep't, University of British Columbia) (arguing that the assumption in Brannon & Morss, note 59, at 599-609, that rates can be changed to reach the desired degree of progressivity, is not necessarily realistic).

<sup>74</sup> Groves, note 59, at 13 (citing A.C. Pigou, *A Study in Public Finance* 101-03 (1928)).

<sup>75</sup> A taxpayer's own personal exemption serves (along with the standard deduction) to protect from tax the income needed for the taxpayer's own subsistence. It is not an adjustment for family size, given that it is available to all taxpayers (except for a taxpayer claimed as a dependent by another taxpayer, IRC § 151(d)(2)) regardless of their family circumstances. Since it is not a family size adjustment, its phaseout raises a different policy question from that discussed in the text concerning the dependency exemption. The effect of the phaseout of the personal exemption could be duplicated, more straightforwardly, by repealing the exemption and replacing it with (1) a \$2,500 zero bracket and (2) an additional .72% "bubble" tax applicable in the income range over which the exemption had been phased out. If such a bubble tax rate makes no sense—and it would certainly be laughed at, if made explicit—a phased out personal exemption also makes no sense.

<sup>76</sup> IRC § 151(d)(3). The phaseout had been scheduled to terminate after 1996, but it was made permanent by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13205, 107 Stat. 416, 462 (repealing IRC § 151(d)(3)(E) relating to the phaseout of personal exemptions). The phaseout of § 151(d)(3) originated in 1990 with the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11104(a), 104 Stat. 1388, 1388-407. In this respect, the phaseout acted as a replacement for former § 1(g), enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 101(a), 100 Stat. 2085, 2097-98, which phased out the 15% rate and personal exemptions.

<sup>77</sup> Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 Wash. & Lee L. Rev. 459, 476 (1993) ("If tax burdens are intended to reflect ability to pay, between two families with equal incomes but of different sizes, the family with fewer members should have a higher tax burden.").

<sup>78</sup> Joseph A. Pechman, *Tax Reform: Theory and Practice*, 1 J. Econ. Persp. 11, 22 (1987) (referring to the concealed brackets caused by the phaseout of exemptions and of the 15% bracket).

exceeds the phaseout threshold.<sup>79</sup> For a taxpayer in the 36% bracket, this amounts to an additional .72% tax rate “bubble” *for each family member*.<sup>80</sup> (The increase is referred to as a rate “bubble,” because the marginal rate drops back down after the phaseout is completed.) Thus a single person finds his marginal tax rate increased by .72% during the phaseout, but a couple with three children faces an additional tax rate of 3.6%.<sup>81</sup> Once the phaseout is completed, the hidden marginal rate increase ends (the bubble bursts), but there is no remaining tax distinction based on family size.

The legislative history of the exemption phaseout offers no principled defense of the technique. Perhaps too embarrassed to try, the authors of the 1986 Senate Report offered no explanation of the policy behind the original phaseout provision.<sup>82</sup> The 1993 House Report on the legislation making the phaseout permanent does only slightly better. The Report merely states that “the progressivity of the individual income tax system would be enhanced . . . by permanently extending . . . the phaseout of personal exemptions for higher-income taxpayers.”<sup>83</sup> It does not explain why Congress should select a method of increasing progressivity that imposes rate bubbles, that varies the size of the bubbles with family size, and that eliminates all family size differentiation at high incomes. One could be forgiven for thinking the phaseout is nothing more than an unprincipled attempt to disguise an increase in marginal rates. Surprisingly, however, a few commentators attempted to make a principled case for phased out exemptions years before Congress became interested.

Writing in 1976, Richard Goode supported a vanishing exemption on the grounds that, although ability to pay requires family size differentiation at income levels close to the socially acceptable minimum, family size becomes irrelevant to ability to pay at some point on the income scale.<sup>84</sup> This argument ignores the fact that, even without a

<sup>79</sup> IRC § 151(d)(3).

<sup>80</sup> A 36% bracket taxpayer with only one exemption (his own), and with AGI in the phaseout range loses \$50 of exemption for each \$2,500 of AGI (\$2,500 exemption x 2% = \$50). The loss of the \$50 of exemption results in additional tax liability of \$18 (\$50 x 36%). An additional tax of \$18 on \$2,500 of income is a tax of .72%.

<sup>81</sup> This is an increase in tax rate of .72% for each of the two personal exemptions and three dependency exemptions phased out.

<sup>82</sup> S. Rep. No. 313, note 60, at 31-36, reprinted in 1986-3 C.B. (vol. 3) at 31-36 (referencing where an explanation would have been, had one been offered). There is no explanation in the House Report, because the House bill did not have a phaseout provision. H.R. Rep. No. 841, 99th Cong., 2d Sess., II-8 (Conf. Rep.), reprinted in 1986-3 C.B. (vol. 4) 8.

<sup>83</sup> H.R. Rep. No. 111, 103d Cong., 1st Sess. 635 (1993), reprinted in 1993-3 C.B. 206.

<sup>84</sup> Richard Goode, *The Individual Income Tax* 219-20 (1976) (arguing that the ability to pay principle does not require differentiation by family size at high income levels and that vanishing exemptions are justifiable); Daniel C. Schaffer & Donald H. Berman, *Tax Exemptions and the Birthrate: The Singleminded Approach to Public Policy*, 3 *Env'tl. Aff.*

phaseout provision, a flat subsistence-based exemption becomes a smaller proportion of income (and of tax liability) as income increases, thus reflecting that in percentage terms family size has *less* effect on ability to pay as income increases.<sup>85</sup> The argument does not explain why this is not enough—why family size has *no* effect on the ability to pay of the affluent. Even at the highest incomes, a large family has less clear income than an equal income, small family, and nonvanishing exemptions reflect that difference.

The real point of the vanishing exemption argument seems to be that, at very high incomes, the choice of a standard of living is limited only by taste, not by resources, so that the presence of more or fewer children has no effect on the family's standard of living. That is probably true, but using it as the basis for denying dependency exemptions to high income taxpayers proves too much. Just as the presence of children has no effect on the standard of living at very high incomes, so the presence of additional income (above some very high level) has no effect on the standard of living. If the irrelevance of children to standard of living means children should have no tax effect, then the irrelevance of additional income to standard of living means that additional income should have no tax effect. This does not merely mean that all very high income taxpayers should pay the same *rate* of tax; it means they should all pay the same *total amount* of tax, even if one has \$1 million of income and another has \$500 million. This is a ludi-

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687, 699 (1974) (some "believe that as income increases the number of one's children eventually becomes irrelevant to one's ability to pay"); Seltzer, note 61, at 6-7 (noting that some argue that, at higher income levels, children should be viewed as discretionary parental consumption).

A different argument for vanishing exemptions is described in Groves, note 59, at 13. This analysis posits that the purpose of progressivity at upper income levels is to moderate excessive concentrations of power, and that the power of a wealthy family does not decrease as children are added. Accordingly, the addition of children should not reduce tax liability. Groves notes that "[i]n this view, if the family's choice is of concern to the state at all, an addition to its ranks might call for increasing rather than decreasing its tax because such addition will augment the demand for public services." *Id.* This is a rather strange argument in more ways than one. First, the standard explanation of progressivity is based on ability to pay, *not* on reducing concentrations of power. Gravelle, note 54, at 8 n.10 ("Progressivity in the tax system is typically based on an equal sacrifice notion and the notion that a dollar to a poor person is much more valuable than a dollar to the wealthy person."). If the main concern were with reducing power concentration, the maximum rate would be much more nearly confiscatory than 39.6%. In addition, it is far from clear that family size is simply irrelevant to the power of wealthy families, as the use of a vanishing exemption would imply. Family power may be *positively* correlated with the number of children, in which case the power analysis would call for a hefty surtax on children of wealthy families. In any event, the family power argument is really tax-external—a call for a tax penalty (reverse tax expenditure) to serve a nontax goal, rather than an attempt to refine the concept of ability to pay.

<sup>85</sup> This is why a flat exemption is progressive, notwithstanding that it produces greater apparent tax savings for higher bracket taxpayers. See note 71.

crous result under an *income* tax;<sup>86</sup> yet it follows from the premise on which the vanishing exemption is based.

Support for a vanishing exemption also may reflect confusion between the tax-internal and the subsidy justifications for child tax allowances. For example, Lawrence Seltzer has explained the rationale for vanishing exemptions in this way: "[A]ll these personal allowances are *needed* in declining amounts as incomes rise, and are not *needed* at all for larger incomes."<sup>87</sup> This seems to mean that affluent parents do not need a subsidy to take care of their children—which is true, but irrelevant as a critique of an allowance never intended as a subsidy. If it is conceded that dependency exemptions are appropriate at lower and middle income levels to reflect differences in ability to pay income tax, there is no persuasive argument for phasing out the exemptions at higher incomes.

### 3. *Adjusting the Standard Deduction for Family Size*

Closely related to the question of phaseout of exemptions is the question of whether exemptions should be replaced (or supplemented) by family size adjustments to the standard deduction. Under current law, the size of the standard deduction is not adjusted on account of dependent children, with one exception: the first dependent of an unmarried taxpayer makes the taxpayer a head of a household, increasing the standard deduction significantly.<sup>88</sup> Together with the exemptions, the standard deduction roughly serves to exempt families at or below the poverty line from income tax.<sup>89</sup> The fact that a standard deduction is allowed for the taxpayer (or taxpayers, in the case of a joint return), but generally is not increased by the presence of dependents, undercuts the formal equality of a taxpayer's own exemption and a dependency exemption.<sup>90</sup> Factoring in the standard deduction, the tax-free income allowed a person on his own account is substantially greater than the increase in tax-free income allowed on

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<sup>86</sup> This result would be proper, however, under a consumption tax. If the two taxpayers had equal consumption (equal standards of living), they would pay the same tax despite the huge difference in incomes.

<sup>87</sup> Seltzer, note 61, at 135 (emphasis added).

<sup>88</sup> For 1995, the increase is from \$3,900 to \$5,750. Rev. Proc. 94-72, note 8, at 17. For a discussion of the policy issues raised by the special tax treatment of heads of households, see text accompanying notes 276-95.

<sup>89</sup> The legislative history of the 1986 Act explicitly states this goal. See S. Rep. No. 313, note 60, at 31-33, reprinted in 1986-3 C.B. (vol. 3) at 31-32.

<sup>90</sup> See Goode, note 84, at 215-17 (explaining that in view of the standard deduction, it is somewhat misleading to say the taxpayer's own exemption is no larger than the exemption for the taxpayer's child).

account of any one dependent. This result is generally consistent with data on the cost of subsistence for households of different sizes.<sup>91</sup>

The amount of the standard deduction could be made more sensitive to family size. In 1991, for example, then-Congressman Panetta proposed increasing the standard deduction by \$1,400 for each dependent.<sup>92</sup> Although this proposal would have retained dependency exemptions at their current levels, a more radical proposal would be to eliminate exemptions entirely, and replace them with family size adjustments to the standard deduction.<sup>93</sup> If the size of the adjustments were the same as the size of the exemptions they replaced, the real effect of this change would be on how the child allowances are phased out at higher incomes. Child allowances in the form of exemptions traditionally have not been phased out at all; they now are explicitly phased out at very high income levels.<sup>94</sup> A child allowance in the form of an increased standard deduction would not be explicitly phased out, but would be subject to the de facto phaseout resulting from the necessity of choosing between the standard deduction and itemized deductions.<sup>95</sup>

Suppose the Panetta bill were enacted, raising the standard deduction for a married couple with one child from \$6,550 to \$7,950. The resulting decrease in taxable income for such a couple would be a function of the amount of their itemized deductions. If their itemized deductions were \$6,550 or less, their taxable income would decrease by the full \$1,400 increase in the standard deduction. As itemized deductions ranged from \$6,551 to \$7,949, the increase in the standard deduction would produce taxable income decreases ranging from \$1,399 to \$1. If their itemized deductions equalled or exceeded \$7,950, the increase in the standard deduction would have no effect on their taxable income.

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<sup>91</sup> For a discussion of the data, see text accompanying notes 128-57.

<sup>92</sup> H.R. 3202, note 32. The U.S. income tax once had a standard deduction sensitive to family size. The Revenue Act of 1964 included a minimum standard deduction of \$200, with a \$100 increase for each dependent (subject to a \$1,000 ceiling). Pub. L. No. 88-272, § 112(a), 78 Stat. 19, 23. The minimum standard deduction was replaced in 1969 by a low income allowance, which also was adjusted for family size. Tax Reform Act of 1969, Pub. L. No. 91-172, § 802, 83 Stat. 487, 676. Congress eliminated differentiation of the low income allowance by family size in 1975. Tax Reduction Act of 1975, Pub. L. No. 94-12, § 201(a), 89 Stat. 26, 28.

<sup>93</sup> For a proposal to replace the exemptions and standard deduction with a support allowance that increases with each dependent, see Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 *Tax L. Rev.* 121, 144-46 (1989).

<sup>94</sup> See text accompanying notes 74-87.

<sup>95</sup> Section 63, defining taxable income, gives taxpayers the choice between taking the standard deduction and itemizing deductions. Section 63(e) provides the rule governing an election to itemize one's deductions.

The amount of the standard deduction does not vary with income,<sup>96</sup> but the amount of itemized deductions tends to vary directly with income.<sup>97</sup> As a result, the higher a taxpayer's income, the more likely it is he itemizes deductions, and so would receive little or no benefit from an increase in the standard deduction—little benefit if the increase caused him to switch to the standard deduction and no benefit if he continued to itemize. The relationship between income level and claiming the standard deduction is quite strong. The Service's data for 1991 tax returns (the most recent data available) indicate that 98.9% of tax returns in the lowest income group (AGI of less than \$5,000) claimed the standard deduction and 94.3% of returns in the highest income group (AGI of \$1 million or more) itemized. In between, the proportion of returns claiming the standard deduction dropped steadily as income increased (except for a slight upturn at the very highest income ranges). The crossover point was around \$40,000: the standard deduction was claimed on 60.3% of returns with AGI of \$30,000 to \$39,999, but on only 42.5% of returns with AGI of \$40,000 to \$49,999.<sup>98</sup>

A de facto phaseout of an increased standard deduction is objectionable for the same reason an explicit phaseout of exemptions is objectionable: Differences in ability to pay based on family size exist

<sup>96</sup> This is true of the standard deduction in its current form, but a standard deduction could be designed as a percentage of income rather than a fixed dollar amount. In fact, the original standard deduction, introduced in 1944, was the lesser of 10% of AGI or \$500. Individual Income Tax Act of 1944, Pub. L. No. 78-315, § 9, 58 Stat. 231, 236-38 (enacting the optional standard deduction for individuals).

<sup>97</sup> This is especially true of the deductions for qualified residence interest, IRC § 163(h)(3), state and local taxes, IRC § 164, and charitable contributions, IRC § 170.

<sup>98</sup>

<i>AGI Range</i>	<i>% of Returns Claiming Standard Deduction</i>
\$1 - \$4,999	98.9
\$5,000 - \$9,999	95.8
\$10,000 - \$14,999	92.2
\$15,000 - \$19,999	88.0
\$20,000 - \$24,999	81.0
\$25,000 - \$29,999	73.0
\$30,000 - \$39,999	60.3
\$40,000 - \$49,999	42.5
\$50,000 - \$74,999	22.7
\$75,000 - \$99,999	8.8
\$100,000 - \$199,999	6.0
\$200,000 - \$499,999	4.9
\$500,000 - \$999,999	7.0
\$1,000,000 or more	5.7
all returns	71.9

Source: Author's calculations, based on data from Internal Revenue Service, Statistics of Income 1991: Individual Income Tax Returns 28, 37 tbl. 1.4 (1994).

at all income levels, but the phaseout ignores those differences at higher incomes. The de facto phaseout is even worse than the exemption phaseout, in two respects. First, it tends to occur at much lower income levels. The exemption phaseout affects only taxpayers with six figure incomes, but most taxpayers with \$50,000 income probably would receive no benefit from increased standard deductions.<sup>99</sup> Second, the de facto phaseout is more arbitrary than an explicit phaseout. Very low income taxpayers who itemize will not benefit from the increased standard deduction, and very high income taxpayers who do not itemize will benefit. If the argument for eliminating family size adjustments because of high income is weak, the argument for eliminating family size adjustments because of, for example, extraordinary medical expenses is even weaker.<sup>100</sup>

### C. Family Income Splitting

#### 1. The Control Principle Versus the Benefit Principle

As noted earlier, dependency exemptions can ensure that families with equal amounts of discretionary income have equal tax liabilities, but they do not distinguish among families on the basis of how many people must share the discretionary income.<sup>101</sup> Whether the number of people sharing the clear income *should* make a difference depends on where one stands in the great debate between the control and benefit principles of income taxation. Under the control principle, income properly is taxed to the person who controls the income (generally the earner, in the case of earned income); under the benefit principle, income properly is taxed to the person who consumes the income.<sup>102</sup> Under the control principle, the adult earner is the proper

<sup>99</sup> It would be an overstatement to claim that no taxpayer who itemized under current law would benefit from a dependent-based increase in the standard deduction. The increase would cause some itemizers to claim the standard deduction instead, especially those with itemized deductions only slightly greater than the standard deduction and those with many dependents. It is not possible to tell from the data on 1991 income tax returns how many itemizers would become nonitemizers if their standard deductions were increased. See note 98.

<sup>100</sup> Even if the standard deduction does not include a family size adjustment, the requirement that taxpayers choose between the standard deduction and itemized deductions is subject to criticism. The most important criticism is that the standard deduction undercuts the policies of the itemized deductions. For example, the tax law does not encourage a person claiming the standard deduction to give to charity. See Boris I. Bittker & Lawrence Lokken, 2 *Federal Taxation of Income, Estates and Gifts* 30-41 (2d ed. 1990) (explaining how the use of the standard deduction as an instrument of progressivity interferes with the policies of many of the itemized deductions). Whatever one may think of the standard deduction generally, however, it is only a standard deduction sensitive to family size that raises the issue discussed in the text.

<sup>101</sup> See text accompanying notes 66-67.

<sup>102</sup> The two principles are discussed in Zelenak, *Marriage*, note 62, at 354-55.



taxpayer on all clear income, and the number of dependents with whom he shares consumption of the income should be irrelevant. Under the benefit principle, each family member should be taxed on the income he consumes, which makes the number of people sharing the clear income crucial for tax purposes.<sup>103</sup>

The choice between the two principles is more a matter of faith than of reason, and advocates on both sides are better at proclaiming than explaining their positions.<sup>104</sup> In two ways, however, the control principle has an edge. First, the Supreme Court has held that ordinarily the touchstone for identifying the proper taxpayer for federal income tax purposes is control of income—thus taxing the earner on earned income<sup>105</sup> and the property owner on income from property.<sup>106</sup> Second, using consumption as the key to identifying the proper taxpayer would make a great deal of sense under a consumption tax (taxing only consumed income); it makes much less sense under an income tax (taxing income whether consumed or saved). If consumption is not the key to the tax base, why should it be the key to the taxpayer?<sup>107</sup>

## 2. *Applying the Benefit Principle*

Assuming, however, that the benefit principle is to guide the income taxation of families,<sup>108</sup> the principle requires that *all* amounts

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<sup>103</sup> Although the text describes the most plausible ways of applying the control and benefit principles to taxation of the family, other views are possible. Under the control test, one might argue that a parent does not control (and thus should not be taxed on) above-subsistence amounts spent on children, because the parent may be legally obligated to spend those amounts. See notes 52, 63-64 and accompanying text. Under the benefit principle, one might view the parent as receiving a consumption benefit from above-subsistence amounts spent on children. This view of expenditures on children as benefitting the parents more than the children becomes more intuitively appealing the more extravagant the expenditures.

<sup>104</sup> On the control side, see note 66. On the benefit side, see Michael J. McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 Harv. L. Rev. 1573, 1577 (1977) ("Taxing the income to those who actually consume or accumulate it regardless of source seems intuitively more equitable [than the control principle] and provides a basic principle to govern how the tax system should take domestic sharing arrangements into account.").

<sup>105</sup> *Lucas v. Earl*, 281 U.S. 111 (1930) (discussing the control principle's application to earned income).

<sup>106</sup> *Helvering v. Horst*, 311 U.S. 112 (1940) (discussing the control principle's application to income from coupon bonds and property more generally).

<sup>107</sup> See Zelenak, *Marriage*, note 63, at 354.

<sup>108</sup> In a recent article, I expressed a preference for taxing spouses according to the control principle (mandatory separate returns) rather than the benefit principle (joint returns aggregating spousal income and taxing it under a special rate schedule). *Id.* at 354-58. That preference was based primarily on concern with the marriage tax penalties and bonuses created by joint returns and by concern with the effect of joint returns on wives' decisions to work. Neither of these concerns is implicated by parent-child income splitting,

actually consumed by children—not just subsistence costs—be taxed to them (rather than to their parents).<sup>109</sup> Since it is not practical to investigate the actual spending behavior of every family, implementation of the benefit principle requires a formula for allocating income among family members.<sup>110</sup> Although the formula cannot be accurate for every family, it should be based on observations of typical family income sharing patterns. As a logical prerequisite to formula-based income splitting within a family, the income of all family members first must be combined to determine the total family income to be allocated by formula.<sup>111</sup> Current law requires limited aggregation of family income—under the “kiddie tax,” unearned income of children under age 14 is taxed as if it were income of the parents<sup>112</sup>—but formula splitting would require complete aggregation.<sup>113</sup>

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so it would not be inconsistent to oppose spousal income splitting but favor parent-child splitting.

<sup>109</sup> As Professors McIntyre and Oldman note, the current system of subsistence-based dependency deductions can be viewed as an allocation to children of the income needed for their subsistence, with that income then taxed at a zero rate. McIntyre & Oldman, note 104, at 1607. This suggests that even the exemption system is inconsistent with a strict application of the control principle, because the subsistence income is taxed to the consuming child, rather than to the controlling adult. There is an undeniable tension between the control principle and dependency exemptions, but there are also two plausible ways of reconciling exemptions with the control principle. First is the simple idea that the parent is not really in control of amounts spent on the basic needs of his children because he is legally obligated for those needs. See notes 52, 63-64 and accompanying text. The problem with this argument is that ordinarily the control that counts for taxation is simply control over the source of the income (such as one's labor). If one controls the income source, a legal obligation to use the income in a particular way (for example, to pay personal interest expense) does not defeat taxation. The second argument is that subsistence income is simply not a proper part of the tax base *for any taxpayer*. Brannon & Morss, note 59, at 602-03. This argument rejects the view of the exemption as allocating income equal to the exemption to the consuming child. The income still is allocated to the earning parent; it is simply not part of the parent's tax base. Even if one finds neither of these arguments convincing, exemptions for the cost of subsistence are a small violation of the control principle, compared to general income splitting within families.

<sup>110</sup> Such a system has long been used in France. For tax purposes, income is divided among family members according to a formula under which each adult is given a weight of 1, and each of the first two children, a weight of .5. Thus, for example, in a two-adult, two-child family, one-third (1/3) of the family income is allocated to each adult, and one-sixth (.5/3) to each child. The third and higher order children are each given a weight of 1. See Joseph A. Pechman & Gary V. Engelhardt, *The Income Tax Treatment of the Family: An International Perspective*, 43 Nat'l Tax J. 1, 9 (1990) (recognizing France's adoption of a quotient system under which tax is calculated on a per capita basis using income splitting). The additional splitting benefits afforded families with more than two children, however, are based on pronatalism, not on the belief it reflects typical spending patterns. *Id.*

<sup>111</sup> Michael J. McIntyre, *Tax Consequences of Family Sharing Practices Under New York Law: A Critique and a Proposal for Reform*, 49 Alb. L. Rev. 275, 332 (1985).

<sup>112</sup> IRC § 1(g) (providing rule under which certain unearned income of minor children is taxed at the parent's marginal tax rate).

<sup>113</sup> Theoretical arguments for and against various models of family aggregation and the practical problems that might be encountered under aggregation are discussed thoroughly

How the design of an allocation formula might be informed by studies of family spending patterns is discussed in detail later in this Article.<sup>114</sup> The major questions include: the typical relationship between the amount spent by a family per adult and the amount spent per child, how family spending on children varies with the number and ages of children, and whether the proportion of family income spent on children varies with family income levels.

As an example of how an allocation formula might work, suppose Congress opts for a formula based on the assumption that families spend \$100 on each adult for every \$40 spent on each child.<sup>115</sup> This implies an allocation formula under which each adult is given a weight of 1 and each child a weight of .4. In a two-adult, one-child family, each adult is allocated  $1/2.4$  (41.7%) of the family income and the child is allocated  $.4/2.4$  (16.7%). The effect of such a formula is that each additional child results in a smaller allocation of income away from the parents, despite the fact that each child is given the same weight by the formula. The first child allocates 16.7% of family income away from the parents, the second child allocates away an additional 11.9%, the third child an additional 9%, the fourth child, 6.9% and the fifth child, only 5.6%.<sup>116</sup> The decreasing allocations away from the parents as more children are added does not mean that younger children receive a smaller share of family income than older children. To the contrary, giving each child a weight of .4 assumes that an equal amount is spent on each child in any given family. The decreasing cost to the parents of additional children is based on two factors. First, if family income is fixed, the family necessarily spends less

in Martin J. McMahon, Jr., *Expanding the Taxable Unit: The Aggregation of the Income of Children and Parents*, 56 N.Y.U. L. Rev. 60 (1981).

<sup>114</sup> See text accompanying notes 170-85.

<sup>115</sup> This is roughly consistent with the findings of one of the leading studies of family expenditures on children. See Lazear & Michael, note 50, at 6.

<sup>116</sup>

Income Allocations in Two-Adult Families  
(Adult = 1, Child = .4)

# of children	% of income allocated to parents	% of income allocated to children	% of income allocated to each child	% of income allocated away from adults by last child
0	100.0			
1	83.4	16.7	16.7	16.7
2	71.5	28.6	14.3	11.9
3	62.5	37.5	12.5	9.0
4	55.6	44.5	11.2	6.9
5	50.0	50.0	10.0	5.6

Percentages may not add to exactly 100% due to rounding.

on each child—including the new child—as the family becomes larger. Second, what income is spent on the new child is reallocated from the existing children as well as from the parents. The more children already in the family, the more resources are shifted to the new child from existing children rather than from the parents.

Once an allocation formula has been chosen, the next question is the tax treatment of the income allocated to the children. Some commentators suggest that the size of dependency exemptions should rise with income, to reflect the larger expenditures on children by higher income parents.<sup>117</sup> Under this approach, all income allocated to a child—including amounts above subsistence needs—would be free of tax. This confuses the question of how much income should be taxed *to the parents* with the question of how much income should be taxed *to anyone*. It makes sense, under the benefit principle, to permit parents to avoid tax on all amounts spent on their children, but it makes no sense to exclude the income from tax entirely merely because it is spent on discretionary consumption of children rather than of adults. Thus, to the extent the formula allocates to a child more income than the child needs for subsistence, it should be taxed to the child. There is no inconsistency in combining subsistence exemptions with formula income splitting, so that each family member is taxed on what that family member consumes (as determined by the income splitting formula) above subsistence (as determined by the exemption).

Given that above-subsistence income allocated to a child should be taxed, how should the applicable rate schedule be designed? The simplest possibility, of course, would be to have a single rate schedule applied to the income allocated to every person, whether child or adult. Proponents of family income splitting, however, often suggest a more nuanced approach.<sup>118</sup> This approach is based on equal sacrifice analysis, which is an elaboration of the concept of imposing tax in accordance with ability to pay.

Assume that families share income between adults and children in the 2.5 to 1 (\$100 to \$40) ratio discussed above, and that an adult needs 2.5 times as much income as a child to be as well-off as the child.<sup>119</sup> One can produce lists of households of different composi-

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<sup>117</sup> See, e.g., Noonan & Dunlap, note 54, at 123-24; Seltzer, note 61, at 103, 108 (explaining, but not endorsing, the position that the size of dependency exemptions should rise with income, to reflect the larger expenditures on children by higher income parents).

<sup>118</sup> See, e.g., James B. Davies, *The Tax Treatment of the Family*, in *Taxation to 2000 and Beyond* 166, 172-73 (Richard M. Bird & Jack M. Mintz eds., 1992) [hereinafter *Taxation to 2000*]; Gravelle, note 54, at 13.

<sup>119</sup> For simplicity, this example also assumes that either family sharing arrangements produce no economies of scale, or it is appropriate for the tax system to disregard economies of scale.

tions and with different incomes that are equally well-off: for example, an unattached person with \$10,000 income, a single parent and child with \$14,000 income, a childless couple with \$20,000 income, a one-child couple with \$24,000 income, a two-child couple with \$28,000, and so on. Being equally well-off, each family has equal ability to pay, and should make an equal sacrifice. That would require imposing a tax liability on each family so that all of the families have identical standards of living after tax, just as they all had identical (but higher) standards of living before tax. This is accomplished, not by imposing the same absolute tax liability on each family, but by imposing the same effective (average) rate of tax on each family. If, for example, tax at an effective rate of 20% was imposed on each family, each adult would be left with \$8,000—the same as every other adult, and 2.5 times the \$3,200 left to every child. Larger families with larger incomes will pay more tax, but all families will make an equal sacrifice.

There are various methods that would achieve this result,<sup>120</sup> but perhaps the simplest to understand (in terms of its relation to the underlying policy) is to divide the family income among its members according to the splitting formula, and then to tax each member's share of family income under the applicable rate schedule, with one rate schedule for adults and another for children.<sup>121</sup> Given the assumption that a child is as well off as an adult with 40% of the adult's income,<sup>122</sup> all the rate brackets under the child rate schedule should be only 40% as wide as the equivalent adult brackets. In practice, the simplest way

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<sup>120</sup> Approaches different from the one described here can be found in Davies, note 118, at 172-73; Gravelle, note 54, at 13.

<sup>121</sup> Calculating the amount of tax by allocating income to each family member does not require actually imposing a tax liability on each member. The liability for tax on income earned by a parent but allocated to a child could (and probably should) remain with the parent. Compare the kiddie tax, IRC § 1(g), which taxes a child's unearned income at the parent's tax rate but leaves the tax liability with the child.

<sup>122</sup> This equivalence of well being would not follow automatically from the observation that an adult spends \$100 on himself for every \$40 he spends on a child. Equivalent well being follows only under the assumption that the adult arranges spending so as to equalize the well being of all family members. One might believe instead that a child needs \$100 to be as well off as an adult with \$100, and that the spending pattern results not from differences in needs, but from the adult favoring himself over the child. Under that assumption, income allocation still would be based on the ratio of \$100 to \$40, but there would be no reason to apply a different tax rate schedule to children from that applied to adults. Lazear and Michael emphasize that they are agnostic on the question of whether a child derives as much well being from \$40 as an adult does from \$100: "[O]ur conclusion that children receive on average only about 40 percent as much as adults does not necessarily indicate that they are deprived or that their utility is dramatically less than that of an adult. But since adults tend to determine the allocation of resources within the family, there is no certainty that the utility of the children and the adults are [sic] equalized." Lazear & Michael, note 50, at 147-48.

to achieve this result would be to report all the family income on a single return, calculating the tax liability according to a rate schedule with bracket widths adjusted for family size. There would be a basic, or reference, rate table applicable to an unmarried childless adult. Other families would use rate schedules with bracket widths determined by the number of adult equivalents in the family, with each adult counting as one adult equivalent and each child as .4. For example, a two-parent, two-child family would use a rate schedule with brackets 2.8 times as wide as the single person brackets. This schedule is the equivalent of allocating income within the family by formula and taxing the income under separate rate schedules for adults and children.

A difficult question under a family income splitting system is whether the taxation of income allocated to children should reflect economies of scale in family living arrangements. Suppose that, because of economies of scale, two children in a two-child family can live as well as an only child on 1.8 (rather than two) times the money.<sup>123</sup> A strict adherent of the equal sacrifice concept would require the tax system to adjust for this, by giving the two children rate brackets only 90% of the width of the only child's brackets. The tax system, however, normally does not attempt to adjust for different consumption efficiencies of different taxpayers.<sup>124</sup> One does not have taxable income because one buys an item on sale, and one does not have a deduction for paying an unnecessarily high price. Nor does the tax system take into account any economies unrelated people may realize by living together.<sup>125</sup>

Given this general tax disregard of efficiency of consumption, it is not clear why there should be an exception for economies of scale within the family.<sup>126</sup> Having said that, however, I must concede that the basic idea of narrower rate brackets for children than for adults is itself based on a special case of consumption efficiency—on the premise that children are more efficient consumers than adults. Perhaps

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<sup>123</sup> The economies of scale might result from the ability to share some goods or from savings from buying goods in larger quantities.

<sup>124</sup> Joseph M. Dodge, *Zarin v. Commissioner: Musings About Debt Cancellations and "Consumption"* in an Income Tax Base, 45 Tax L. Rev. 677, 680-81 (1990).

<sup>125</sup> The Senate Report on the 1986 Act justified imposing tax on single people with incomes below the official poverty level on the basis that they were probably enjoying consumption economies not reflected in their taxable income. S. Rep. No. 313, note 53, at 33, reprinted in 1986-3 C.B. (vol. 3) at 33. This involves no attempt to determine what economies of scale, if any, particular individuals realize.

<sup>126</sup> Neil Brooks, Comment, in *Taxation to 2000*, note 118, at 200, 205-06 (arguing, with respect to spouses, that the tax system should not take into account even proven economies of scale); Michael J. McIntyre, Commentary, in *Taxing the Family*, note 66, at 98, 100-01 (arguing that considering economies of scale in taxing the family would open a Pandora's box of problems regarding taxation of the analogous benefits of consumer surplus).

the best solution is to take the coward's way out. The evidence suggests that the economies of scale are not large—that each additional child is only 5 to 10% less expensive than the last (at the same standard of living).<sup>127</sup> Whatever may be said, in theory, for or against accounting for economies of scale, a concern for simplicity justifies ignoring economies this small.

#### *D. Evidence on the Costs of Children, At and Above Subsistence*

##### *I. At Subsistence*

###### *a. Poverty Thresholds*

If subsistence means something more than just staying alive, then it is a social construct, not a fact of nature. In the words of Adam Smith, there are goods not strictly necessary for survival that “the custom of the country renders it indecent for creditable people, even of the lowest order, to be without.”<sup>128</sup> What constitutes subsistence in this sense is a matter of opinion. The opinions necessary to construct poverty thresholds may come from either experts or opinion surveys of the general public.<sup>129</sup> The official U.S. poverty measure is based on the expert approach and serves a number of purposes.<sup>130</sup> It is used in statistical analysis and in determining eligibility for various federal assistance programs. Congress also has relied on it in setting the levels of the standard deduction and the personal and dependency exemptions.<sup>131</sup>

<sup>127</sup> Thomas J. Espenshade, *Investing in Children* 4 (1984) [hereinafter *Investing*].

<sup>128</sup> 1 Adam Smith, *Wealth of Nations* 691 (1776).

<sup>129</sup> Patricia Ruggles argues that opinion surveys that ask people what is the minimum amount they would need to “make ends meet” are not appropriate for official poverty guidelines: “[T]his type of measure, by comparing welfare rather than economic circumstances across individuals, violates the basic axiom that policies whose aims are primarily economic should be evaluated with measures that focus on economic well-being.” Patricia Ruggles, *Drawing the Line: Alternative Poverty Measures and Their Implications for Public Policy* 20, 23 (1990).

<sup>130</sup> Strictly speaking, there are two official poverty measures. The measure used for statistical analysis is determined by the Census Bureau retrospectively, based on the price changes that occurred in the previous year. See, e.g., Bureau of the Census, U.S. Dep’t of Commerce, *Statistical Abstract of the United States* 1993, at 440-41 (113th ed. 1993) [hereinafter *Census Abstract*] (describing the method used by the Census Bureau to classify families and unrelated individuals as being above or below the poverty level). The measure used for program eligibility is determined prospectively, for application in the upcoming year, by the Department of Health and Human Services (“HHS”). See, e.g., HHS, *Annual Update of the HHS Poverty Guidelines*, 59 Fed. Reg. 6277 (1994) [hereinafter *HHS Poverty Guidelines*] (providing an update of the HHS poverty guidelines to account for the last calendar year’s increase in prices as measured by the Consumer Price Index).

<sup>131</sup> Staff of the Joint Comm. on Tax’n, 99th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1986*, at 15-16 (Comm. Print 1987) [hereinafter 1986 Bluebook].

This measure is based on studies conducted by Mollie Orshansky for the Social Security Administration during the 1960's.<sup>132</sup> Her method was simple. She took minimally adequate food budgets calculated by the Department of Agriculture for families of various sizes and compositions, and multiplied those budgets by three on the assumption that food normally accounted for about one-third of household expenditures.<sup>133</sup> She adjusted upwards the poverty thresholds for one- and two-person families to reflect their higher fixed costs (primarily for housing).<sup>134</sup> With annual adjustments for inflation as measured by the Consumer Price Index,<sup>135</sup> and a few other minor changes, the official poverty measure continues to be based on these studies.

The family size adjustments in the official poverty measure are not uniform, and some of the irregularities are quite strange. For example, the marginal cost of a fourth family member is substantially greater than that of a second or third family member, and the seventh member is more expensive than the sixth.<sup>136</sup> This implies, counterintuitively, that in some cases there are negative economies of scale associated with increasing family size. Apparently, however, the irregularities are due not to negative economies of scale, but to the fact that the food budgets used by Orshansky were adjusted for children's ages, and at certain family sizes, the marginal child tended to be older (and so more expensive to feed) than at others.<sup>137</sup>

In her excellent study of the problems in defining and measuring poverty, Patricia Ruggles argues convincingly that simply updating decades-old poverty thresholds for inflation is insufficient.<sup>138</sup> Because there has been significant growth in real incomes since the thresholds were established, the thresholds have declined as a portion of median income from about one-half in the 1960's to about one-third today.<sup>139</sup> To the extent that poverty is a relative rather than an absolute concept, those at the poverty line today are poorer than those at the poverty line when it was developed. In addition, an inflation adjustment

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<sup>132</sup> The studies include Mollie Orshansky, *Counting the Poor: Another Look at the Poverty Profile*, Social Security Bull., Jan. 1965, at 3; Mollie Orshansky, *Children of the Poor*, Social Security Bull., July 1963, at 3 [hereinafter *Poor Children*]; see also Ruggles, note 129, at 4.

<sup>133</sup> Orshansky, *Poor Children*, note 132, at 8-9.

<sup>134</sup> *Id.* at 10-11; see also Ruggles, note 129, at 11 n.3.

<sup>135</sup> Ruggles, note 129, at 41.

<sup>136</sup> *Id.* at 65-66. These irregularities exist in the Census Bureau poverty thresholds, but they have been smoothed out in the HHS poverty guidelines. The HHS 1994 guidelines increase by \$2,480 for every family member. HHS Poverty Guidelines, note 130, at 6277.

<sup>137</sup> Orshansky, *Poor Children*, note 132, at 10-11; see also Ruggles, note 129, at 66-67.

<sup>138</sup> Ruggles, note 129, at 39-54.

<sup>139</sup> *Id.* at 19, 45.



does not reflect changing patterns of consumption, and changing opinions about what goods are necessary, over long periods of time.<sup>140</sup> Ruggles' preference is for a thorough overhaul of the official poverty measure, based on "a detailed examination of changes in the costs of a complete market basket of necessary goods . . . since the mid-1960s."<sup>141</sup> As a simpler alternative, she suggests updating the Orshansky method by multiplying food costs by five instead of three, to reflect the fact the typical family today spends no more than one-fifth of its budget on food.<sup>142</sup> This simple change would result in poverty levels about 67% higher than under the current measure. Ruggles concludes that "poverty standards today, to be comparable in terms of their consumption implications to the original Orshansky thresholds, would have to be at least 50 percent higher than the official thresholds."<sup>143</sup>

Ruggles notes that decades-old information on family food consumption is not the most impressive data base for adjusting the poverty thresholds for differences in family size,<sup>144</sup> and so she also recommends that government statistical agencies directly reestimate how subsistence needs vary with family size.<sup>145</sup> She finds, however, that the elasticity of need with respect to family size implicit in the official poverty measure is roughly consistent with the results of other studies,<sup>146</sup> so she would not expect new estimates to differ greatly from the current thresholds (with their irregularities smoothed out<sup>147</sup>) in terms of the ratios between the subsistence needs of families of different sizes.<sup>148</sup> Although the current poverty thresholds are too low for all family sizes, they are probably too low by approximately the same percentage at all sizes. All this suggests that the subsistence allowances in the income tax that are inspired by the official poverty thresholds—the standard deduction and the exemptions—should be increased across the board by at least 50%. Such an adjustment would

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<sup>140</sup> See *id.* at 47-52 (noting that, for example, indoor plumbing and electricity are seen as necessary today, while at one point they were luxuries).

<sup>141</sup> *Id.* at 51.

<sup>142</sup> *Id.* at 50 (noting that this is due to increases in the price of other items like housing and medical care).

<sup>143</sup> *Id.* at 167.

<sup>144</sup> *Id.* at 64.

<sup>145</sup> *Id.* at 77.

<sup>146</sup> *Id.* (noting that family size elasticity of need "is an index that varies between 0 and 1, with larger elasticities implying smaller economies of scale").

<sup>147</sup> The irregularities are a quirk of the food budgets used by Orshansky. See text accompanying notes 136-37.

<sup>148</sup> Ruggles, note 129, at 77.

increase the current \$2,500 dependency exemption to close to \$4,000.<sup>149</sup>

It is possible that a careful study of the effect of family size on subsistence needs would find that the marginal cost of children decreases as family size increases—in other words, that there are economies of scale in the subsistence needs of children. That the current thresholds do not reflect this<sup>150</sup> may result from their being based on a multiplier of food, rather than on a broader market basket of basic needs. Food is especially resistant to economies of scale. It may be slightly less expensive purchased in bulk, but unlike many other subsistence needs—such as housing and transportation—it cannot be shared. Intuition suggests that better data probably would lend support to some decrease in the size of additional dependency exemptions as family size increased.<sup>151</sup>

On the other hand, what evidence exists suggests the economies of scale are quite modest, on the order of 5 to 10%.<sup>152</sup> It is true that expenditure studies of families with above subsistence incomes find that each additional child results in a substantially smaller increase in total family spending on children than the increase caused by the previous child.<sup>153</sup> This result is caused not by economies of scale, however, but by parents paying for the new child largely by reallocating expenditures from existing children to the new child.<sup>154</sup> This phenomenon is irrelevant to determining the cost of subsistence, because at the subsistence level, existing children have no surplus that can be re-

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<sup>149</sup> The reasonableness of this figure is supported by comparison with the Agriculture Department's recent study of expenditures on children, which found that two-parent families with two children and less than \$32,000 income spent an average of \$5,428 annually per child. Family Economics Research Group, U.S. Dep't of Agriculture, *Expenditures on a Child by Families*, 1993, at 16 tbl. A (1994) [hereinafter *Child Expenditures*] (total child expenditures for first 18 years of life for two-parent, two-child families per child; figure derived by dividing \$97,710 by 18). These families had average incomes of \$20,000, suggesting they had only limited opportunity to pay for above-subsistence consumption by their children.

<sup>150</sup> The smoothing out of the irregularities of the family size adjustments by the HHS results in a constant \$2,480 increment for each additional family member. HHS *Poverty Guidelines*, note 130, at 6277.

<sup>151</sup> If there are economies of scale in the subsistence cost of children, it is clear in theory that those economies should be reflected in decreases in the amount of dependency exemptions. If each additional child reduces parental discretionary (clear) income by less than the previous child, only decreasing exemptions will result in the accurate measurement of discretionary income. By contrast, it is not clear whether economies of scale above the subsistence level should be reflected under a family income splitting system. See text accompanying notes 123-27.

<sup>152</sup> See Espenshade, *Investing*, note 127, at 4. Espenshade's study examined actual expenditures by families on children at all income levels, not just at subsistence. *Id.*

<sup>153</sup> See text accompanying notes 115-16, 178-79.

<sup>154</sup> See Espenshade, *Investing*, note 127, at 4.

allocated to a new child.<sup>155</sup> The simplicity and egalitarianism of level dependency exemptions is sufficiently attractive that Congress should resist changing to decreasing exemptions unless economies of scale at the subsistence level are both firmly proven and more substantial than 5 or 10%.

A similar analysis applies to the possibility of adjusting the dependency exemption for the age of the child. There is considerable evidence that the subsistence food needs of children increase as they grow older.<sup>156</sup> It would be defensible to reflect these differences in age-sensitive dependency exemptions,<sup>157</sup> but the gain in precision does not seem worth the loss in simplicity. This is especially true for age-based adjustments, since any inequities will tend to even out as a child passes through both the cheaper and the more expensive years.

*b. The Significance of 1948*

The premise of the above analysis has been that dependency exemptions should reflect the cost of supporting a child, at subsistence, in the current year. Eugene Steuerle has developed a different analysis, based on the dependency exemption levels of 1948, and he and others have used it to considerable rhetorical effect. Steuerle observed, in the course of arguing for increased exemptions (or a large credit as a replacement for exemptions), that the \$600 exemption of 1948 sheltered a much larger percentage of per capita personal income than does today's exemption.<sup>158</sup> In 1991, for example, the dependency exemption would have to have been about \$7,800 to have kept pace since 1948 with inflation and real income growth.<sup>159</sup> Others have echoed his invocation of 1948 as the golden year of exemptions, including Senator Moynihan,<sup>160</sup> the National Commission on Children<sup>161</sup> and the Progressive Policy Institute.<sup>162</sup>

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<sup>155</sup> Robert G. Williams, Advisory Panel on Child Support Guidelines, Development of Guidelines for Child Support Orders: Advisory Panel Recommendations and Final Report II-34 to II-35 (1987) [hereinafter *Child Support Guidelines*].

<sup>156</sup> Child Expenditures, note 149, at 16 tbl. A (showing that two-parent, two-child families with incomes below \$32,000 spent \$730 annually on food for a child under two, and \$1,490 for a child age 15 to 17); see Ruggles, note 129, at 67 (noting that the food budgets used by Orshansky to construct her poverty thresholds reflected higher food costs for older children).

<sup>157</sup> By this standard, proposals to allow an increased exemption or a special credit only to the parents of young children seem to get it exactly backward. These proposals are discussed in the text accompanying notes 325-31.

<sup>158</sup> See Steuerle, Households, note 70, at 74; Steuerle & Juffras, note 34, at 5.

<sup>159</sup> Steuerle & Juffras, note 34, at 5.

<sup>160</sup> See Tax Policy Hearings, note 70, at 10-12.

<sup>161</sup> See *Beyond Rhetoric*, note 34, at 85-86 (observing that the value of the personal exemption has eroded substantially since 1948, causing the average family of four's tax liability to increase from .3% of income to 9.1% today).

The problem with the 1948 argument that the current exemption is too small is that it does not explain what was so special about the 1948 exemption level. The official explanation for the \$600 level, in the 1948 Ways and Means Committee Report, does not explain the magic of the number: "Th[e] increase in the cost of living is the reason your committee's bill provides a \$100 per capita increase in exemptions from \$500 to \$600."<sup>163</sup> This does not inspire confidence that Congress got it right in 1948, and that all subsequent exemption levels should be judged against that standard. It does not even suggest that there was any theoretical underpinning for the choice of \$600.<sup>164</sup>

If pressed, those who rely on 1948 probably would concede there is no evidence that Congress was divinely inspired in that year. They would respond, however, that at least Congress made a conscious choice of exemption level in 1948, whereas the subsequent erosion of the exemption by inflation and real income growth resulted from congressional inattention rather than from deliberate policy.<sup>165</sup>

The response is unpersuasive, for two reasons. First, Congress certainly was aware that there was inflation and real income growth after 1948, and that the exemption level was not indexed for either. Acquiescence in the resulting erosion of the exemption may have been a genuine policy choice, notwithstanding that it did not require legislation. Allowing the exemption to erode may have been an attractive way of meeting revenue needs, especially because the political power of large families decreased as the size of the average family dwindled.<sup>166</sup> Second, even if the real value of the exemption was allowed to drift unattended for a time, that time has clearly ended. In 1986, Congress revisited the question of the exemption level and set it with the stated purpose of exempting the poverty threshold from tax.<sup>167</sup> To prevent erosion of the exemption, it also provided for annual adjustments for changes in the Consumer Price Index.<sup>168</sup> After the consid-

<sup>162</sup> Kamarck & Galston, note 39, at 23.

<sup>163</sup> H. Rep. No. 1274, 80th Cong., 2d Sess. 20, reprinted in 1948-1 C.B. 241, 256 (1948).

<sup>164</sup> See Gravelle, note 54, at 11 (noting that "[s]ince past family differentiation was not due to an articulated theory about equitable treatment of differing families, there is no reason that current tax treatment should conform to any past standards"). Gravelle also notes that "[r]evenue needs vary over time." *Id.*

<sup>165</sup> Over the past few decades, the tax system has forced households with children to bear a larger share of the total tax burden. This was not the result of deliberate policy, but was due in part to policymakers' failure to increase the dependent exemption in step with rises in individual income.

Steuerle & Juffras, note 34, at 5.

<sup>166</sup> From 1960 to 1985, the size of the average American family fell from 3.67 members to 3.23 members. Census Abstract, note 130, at 55 tbl. 65.

<sup>167</sup> See 1986 Bluebook, note 131, at 15-16.

<sup>168</sup> IRC § 151(d)(4) (inflation adjustment); see Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 104, 95 Stat. 172, 188-89 (1981) (introducing term "exemption

eration given to the exemption level by Congress in 1986, it is no longer plausible to claim that any difference between the current exemption level and the golden year of 1948 is the result of congressional lassitude or inattention. This does not mean current exemption levels are just right; in fact, I believe they are too low because they are based on a flawed measure of poverty.<sup>169</sup> It does mean, however, that the case for a larger exemption is not furthered by comparisons with 1948.

## 2. *Above Subsistence*

If the income tax were to allocate income between family members according to a formula intended to reflect typical income splitting behavior, it would be crucial to determine how most families actually divide spending between adults and children. Since this is a question of how families *actually* behave, the necessary information must come from consumer expenditure studies, not from expert opinion on how family income *should* be allocated. It is very difficult to study intrafamily spending patterns, because of both the practical difficulty in observing the allocation within families of private goods and the theoretical difficulty of apportioning between family members the costs of shared goods.<sup>170</sup>

The two leading American examinations of this issue are a 1984 study by Thomas Espenshade and a 1988 study by Edward P. Lazear and Robert T. Michael.<sup>171</sup> Both are based on data from the 1972-73 Consumer Expenditure Survey ("CES") administered by the Bureau of Labor Statistics.<sup>172</sup> The CES data is collected at the household level,<sup>173</sup> so it does not readily yield information on intrafamily spending patterns. Deriving spending on individual family members from the household data requires some rather heroic assumptions.

The two studies adopt very different strategies. Espenshade measures the percentage of family consumption expenditures devoted to food at home, and assumes that two families with the same percentage

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amount" and setting it, in part, with regard to Consumer Price Index). Congress did not provide for adjustment of the exemption for growth in per capita real income, but given the inclusion of the inflation adjustment, that was probably a considered decision. See id.

<sup>169</sup> See text accompanying notes 128-57.

<sup>170</sup> Espenshade, *Investing*, note 127, at 19; Lazear & Michael, note 50, at 20.

<sup>171</sup> Espenshade, *Investing*, note 127; Lazear & Michael, note 50.

<sup>172</sup> This survey is the most complete source of household expenditure information in the United States. The most recent available data is from the 1990 survey, but no study of comparable thoroughness to the studies by Espenshade and by Lazear and Michael have been completed using the 1990 data. A less ambitious analysis of the 1990 data is reported in *Child Expenditures*, note 149, at 16 tbl. A.

<sup>173</sup> See Espenshade, *Investing*, note 127, at 19 (describing the process).

have the same standard of living.<sup>174</sup> Thus, for example, if a typical childless couple with \$20,000 total consumption devotes 25% (\$5,000) of its consumption to food at home, and a typical two-child couple with \$32,000 total consumption also spends 25% (\$8,000) on food at home, the two families are assumed to be equally well off. The final step is to identify the \$12,000 expenditure difference between the two families as the total expenditures on the children. Lazear and Michael, by contrast, use equal spending on observable adult goods (adult clothing, alcohol and tobacco) to equate families of different sizes;<sup>175</sup> from there, they identify spending on children using the same basic technique as Espenshade.

The results are quite sensitive to the approach chosen. Espenshade estimates that for every \$100 spent on each adult member, the typical family spends \$67 on each child.<sup>176</sup> Lazear and Michael conclude that the typical family spends only about \$40 on a child for every \$100 spent on an adult.<sup>177</sup> This is a substantial difference for two sophisticated studies using the same data base. It indicates that any adult-child spending ratio adopted for tax purposes necessarily will be somewhat arbitrary. It also suggests, however, the adoption of a 2:1 ratio as a simple ratio that approximately splits the difference between the two studies.

Despite this significant difference in results, the studies reinforce each other in two important ways. First, they both conclude that marginal expenditures on children decrease significantly with each additional child.<sup>178</sup> If there is a constant relationship between spending

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<sup>174</sup> This is sometimes referred to as the Engel estimator, after its originator, Ernst Engel. Espenshade defends its use at some length. Espenshade, *Investing*, note 127, at 87-98. It has its detractors, however. Milton Friedman has argued that there is no logical basis for the assumption that families spending the same percentage of their total consumption on food have the same level of well being. Milton Friedman, *A Method of Comparing Incomes of Families Differing in Composition*, 15 *Stud. in Income & Wealth* 9 (1952).

<sup>175</sup> Lazear & Michael, note 50, at 24-25, 77-82. This is sometimes referred to as the Rothbarth estimator. See generally Erwin Rothbarth, *Notes on a Method of Determining Equivalent Income for Families of Different Composition*, in *War-Time Pattern of Savings and Spending* 123 (Charles Madge ed., 1943). This approach has been criticized for its volatility, resulting from the fact that observable adult goods tend to be only a small fraction of total family consumption. See *Child Support Guidelines*, note 155, at II-19. Lazear and Michael themselves concede this is a weakness of the technique. Lazear & Michael, note 50, at 79.

<sup>176</sup> In his book, Espenshade does not report his findings in these terms. He converts his findings to these terms in his review of the Lazear and Michael study. Thomas Espenshade, *Allocation of Income Within the Household*, 51 *J. Marriage & Fam.* 546, 547 (1989) (book review).

<sup>177</sup> Lazear & Michael, note 50, at 193-94.

<sup>178</sup> Espenshade found expenditures on children by families in the middle socioeconomic group, in one-, two- and three-child families, were in the ratio of 106.2/164.8/206.4. Thus, marginal expenditures were in the ratio of 106.2/58.6/41.6. Espenshade, *Investing*, note 127, at 27 tbl. 3. This was not due primarily to economies of scale, which Espenshade

per adult and spending per child, such as 1/4 or 1/67, this phenomenon of decreasing marginal child expenditures necessarily follows.<sup>179</sup> Second, both studies found that although expenditures on children increase with family income, they do so less than proportionately. Lazear and Michael estimated the income elasticity of spending on children at .9.<sup>180</sup> Espenshade found that expenditures on children as a percentage of total family *consumption* were almost constant across income levels, but that they declined as a percentage of total family *income* (pretax) as income rose.<sup>181</sup> In part, this reflects an increasing percentage of family income going to taxes at higher incomes, but it also reflects increasing income going to savings rather than to consumption.<sup>182</sup> If a family income splitting formula is to reflect this, it must provide for different intrafamily income allocations at different income levels (unless children share in family savings to the same extent they share in family consumption).

Another significant finding of Espenshade's study is that expenditures on a child increase with the child's age, especially after age six.<sup>183</sup> Lazear and Michael did not find that age had any significant effect on expenditures,<sup>184</sup> but their failure to do so is quite unusual in the literature on expenditures on children.<sup>185</sup> Again, adjusting the income splitting formula for the age of the child would considerably complicate the tax system.

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found to be quite small. *Id.* at 4. Nor does it mean that families discriminated against later-born children. Rather, much of the money spent on the marginal child was reallocated to that child from existing children. The marginal cost to the parents, then, is the expenditures on the last child minus the decreased expenditures on existing children. Lazear and Michael found the same trend. The ratio of total spending on children in one-, two- and three-child families was 25.7/41.9/52.4, resulting in marginal expenditures in a ratio of 25.7/16.2/10.5. Lazear & Michael, note 50, at 8.

<sup>179</sup> See text accompanying notes 115-17.

<sup>180</sup> Lazear & Michael, note 50, at 95.

<sup>181</sup> Espenshade, *Investing*, note 127, at 67.

<sup>182</sup> *Id.*; Child Support Guidelines, note 155, at II-26.

<sup>183</sup> Dividing childhood into three six-year portions, 26% of total spending on a child occurs during the first six years, 36% during the middle years and 38% during the last six years. Espenshade, *Investing*, note 127, at 6.

<sup>184</sup> Lazear & Michael, note 50, at 180-81.

<sup>185</sup> "Taken together, the evidence on the pattern of expenditures for children under age 12 is somewhat inconclusive. All studies suggest, however, that spending on teenagers (children aged 12 and over) is considerably higher than spending on younger children." Child Support Guidelines, note 155, at II-36. Using 1990 CES data, the Family Economics Research Group found a general (although not perfect) trend toward increasing expenditures on children as they grow older. Child Expenditures, note 149, at 16 tbl. A, 22 tbl. G.

## IV. CHILD ALLOWANCES AS TAX EXPENDITURES

A. *Subsidizing Children*

The most common reason for subsidizing behavior through the tax system is a desire to encourage more of that behavior.<sup>186</sup> Although a few American commentators have argued for tax subsidies for families with children in order to encourage fertility,<sup>187</sup> they do not represent the mainstream of child tax subsidy proponents. There are two major arguments for a tax subsidy for children: the welfare argument and the externalities argument.

The welfare argument sees the provision of a child tax allowance as a continuation, at higher income levels, of the premise underlying the current Aid to Families with Dependent Children ("AFDC") child welfare system. This is explicit in the justification for the \$1,000 per child tax credit originally advocated by Eugene Steuerle and Jason Juffras of the Urban Institute and later championed by the National Commission on Children.<sup>188</sup> Steuerle and Juffras claim that a refundable child tax credit is the appropriate response to the welfare needs of children: "Those with equal needs are served equally under the child credit."<sup>189</sup> Similarly, Steuerle has argued that a refundable child tax credit can be used to ensure a minimum level of well being for every child.<sup>190</sup>

The externalities argument is that well-raised children become valuable members of society. Since parental investment in children produces important positive externalities for society at large, it makes sense for society to encourage that investment through a tax subsidy. This argument is not pronatalist, because the goal is to encourage parents to invest more in each child they choose to have, not to encourage them to have more. This view of children as a good investment for society is popular with both the right and the left. On the left, the Progressive Policy Institute notes that Western European

<sup>186</sup> For example, tax subsidies for investments in business plant and equipment long have been used to encourage such investments. See Lawrence Zelenak, *Do Anti-Tax Shelter Rules Make Sense? A Reply to Professor Johnson*, 68 *Tex. L. Rev.* 491, 497-500 (1989).

<sup>187</sup> Ben Wattenberg's argument that the income tax should be used to further a pronatalist policy attracted considerable attention in the late 1980's. Ben J. Wattenberg, *The Birth Dearth* 150-51 (expanded and updated ed. 1989). Others have argued for an antinatalist policy, involving tax penalties (negative subsidies) on families with children. Use of the tax law to influence fertility is discussed in the text accompanying notes 239-59.

<sup>188</sup> See Steuerle & Juffras, note 34, at 6-7; *Beyond Rhetoric*, note 34, at 79-115. Steuerle and Juffras would integrate their proposed credit with the welfare system, so that at the poverty level, the \$1,000 credit would replace \$1,000 of AFDC benefits. This would avoid the bureaucracy, stigma and state-by-state variations involved in AFDC. See Steuerle & Juffras, note 34, at 6-7.

<sup>189</sup> Steuerle & Juffras, note 34, at 8.

<sup>190</sup> See Steuerle, *Households*, note 70, at 79-80.



countries recognize that "nurturance has great societal value";<sup>191</sup> while on the right, the Heritage Foundation claims children should be viewed as a "socially beneficial private investment."<sup>192</sup> Although well-raised children eventually can benefit society in many ways, one often emphasized is their role as the income and Social Security taxpayers of tomorrow.<sup>193</sup>

The critique of dependency exemptions as upside-down subsidies, which was out of place with respect to child tax allowances designed to reflect differences in ability to pay,<sup>194</sup> is compelling with respect to child tax allowances intended as subsidies. A tax allowance intended to promote child welfare should not produce larger tax savings for higher income families. Nor is there any apparent reason why a subsidy to encourage greater parental investment in children should increase with income. If the intent is a subsidy, a credit is superior to an exemption.

The weak link in any case for credits is the relationship between the tax subsidy and parental spending on the child. This is true whether the focus is on the basic welfare needs of the child, or on the eventual societal payoff from investment in the child. Proposals for a universal child tax credit do not premise the credit on proof of any actual expenditures on the child; parents would receive the credit even though they spend little or none of it on the child.<sup>195</sup> Even though a subsidy is premised on the presence of a child in the family, parents will view the subsidy simply as additional family income and will spend it on family members in the same proportions they spend any other income. If, for example, the typical two-parent, one-child family spends about one-sixth of its income on the child,<sup>196</sup> the child would receive only that proportion of the child's tax subsidy. A response might be that it is acceptable for most of the benefit to go to the parents—it is their reward for helping society by raising a good citizen. The problem is that the credit is not premised on the quality of the parenting (either in terms of how hard the parents try or how well the child turns out), but only on the existence of the child in the parent's household.

In short, there is no reason to expect that society will get much return on a tax subsidy that requires so little of parents beyond adding

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<sup>191</sup> Kamarck & Galston, note 39, at 22 (supporting a proposal to raise the dependency exemption for young children).

<sup>192</sup> See Reclaiming the Tax Code, note 35, at 52 (in the context of a child tax proposal).

<sup>193</sup> *Id.* at 53 (Social Security tax); Davies, note 118, at 197 (income tax).

<sup>194</sup> See text accompanying notes 68-73.

<sup>195</sup> This is a problem with the proposal of Steuerle and Juffras to use the \$1,000 credit to displace \$1,000 of AFDC benefits. See Steuerle & Juffras, note 34, at 6-7. For all its faults, the welfare system provides at least minimal monitoring of a child's welfare as a condition of continuing receipt of benefits by the parent.

<sup>196</sup> Lazear & Michael, note 50, at 6.

the child to the family. Nevertheless, the United States is out of step among industrialized nations in not having some sort of universal family allowance,<sup>197</sup> and proposals for a child tax credit are numerous.<sup>198</sup> Therefore, it is worthwhile to consider the major issues in designing a child credit. The key issues are how large the credit should be, whether it should be refundable, whether it should be phased out as income rises, whether it should be combined with an exemption and whether it should be taxable.

### *B. Designing a Credit*

#### *1. The Size of the Credit*

At least in theory, the logic of the tax-internal argument for a dependency exemption dictates the size of the exemption: equal to a child's subsistence needs.<sup>199</sup> It is much more difficult to determine the theoretically correct amount of a child tax credit. The credit *could* be set at the level of the child's subsistence needs—that is, the same dollar amount as a subsistence-level dependency exemption—but as a grant, rather than merely a tax exemption, of that amount. This would amount to government payment of the full subsistence costs of children in families at all income levels.<sup>200</sup> No one has seriously proposed so large a credit, because of the tremendous revenue cost and more fundamentally because of a widely shared belief that the basic needs of children are the responsibility of their parents as long as the parents are financially able to meet those needs. With the rejection of primary governmental responsibility for the basic needs of all children, the choice of credit size becomes arbitrary. The size of serious credit proposals is driven primarily by the question of how much the government can afford, which is largely a question of how large a credit could be financed by repeal of the current dependency exemption.<sup>201</sup>

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<sup>197</sup> See Kamerman & Kahn, note 68, at 354-56 (noting that most industrialized nations provide family allowances to some degree).

<sup>198</sup> See text accompanying notes 31-41.

<sup>199</sup> See text accompanying notes 59-73. Similarly, the tax-internal argument for family income splitting dictates that family income be split according to typical family sharing patterns. See text accompanying notes 108-16.

<sup>200</sup> A system could be designed to cover the entire subsistence needs of children in low income families, without extending such generosity throughout the income scale. This would require the use of a phaseout device. Credit phaseouts are discussed in the text accompanying notes 211-31.

<sup>201</sup> Steuerle and Juffras would finance much of their \$1,000 credit with repeal of the dependency exemption. Although their proposal would be more expensive than exemptions, they would make up the difference in other ways. Steuerle & Juffras, note 34, at 16.

The child credit could be set at an amount equal to the tax savings from a subsistence exemption at the lowest positive tax rate.<sup>202</sup> The current \$2,500 exemption and 15% bracket would call for a \$375 credit. The apparent rationale for this approach is that a credit calculated by applying the exemption to the lowest tax bracket achieves the goal of not taxing the *first* dollars of income—which is the appropriate goal under a plan based on protecting subsistence income from tax.

This concern with protecting subsistence income from tax is not grounded in subsidy analysis, but in ability to pay. The rationale, however, does not survive scrutiny. A deduction against a parent's lowest bracket simply does not adjust appropriately for differences in ability to pay. Consider *Couple A* with one child and \$52,500 taxable income before any child tax allowance and *Couple B* with no children and \$50,000 taxable income. Assuming the subsistence cost of the child is \$2,500, the two couples have the same amount of discretionary income and should have the same tax liability. They would have the same tax liability if *Couple A* had a \$2,500 exemption "off the top." They would not have the same tax liability if *Couple A* was allowed a \$375 credit (a \$2,500 deduction against 15% bracket income). Both couples would pay tax on the same amount (\$50,000 of income), but they would *not* pay tax at the same rates: *Couple A* would have \$2,500 less income taxed in its 15% bracket and \$2,500 more income taxed in its 28% bracket, resulting in an additional tax liability of \$325.

Child credits viewed as the equivalent of 15% bracket deductions would absorb much or all of the parents' 15% bracket, if they have several children. If the 15% bracket were eliminated, the parents would jump immediately from a zero rate to a 28% tax rate—a nonsensical result. If exempting a given amount of income from low-bracket tax rates because of family responsibility is appropriate, why is it then appropriate to immediately tax remaining income at higher brackets (for example 28%)? Parents in that situation should not be treated as having income flowing directly from untaxed subsistence to highly taxed affluence.<sup>203</sup> Clearly, viewing a credit as a deduction from the bottom of the income pile is illogical.

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<sup>202</sup> Tax Policy Hearings, note 70, at 16; What Do Families Need?: Hearings Before the House Select Comm. on Children, Youth, and Families, 99th Cong., 1st Sess. 16 (1985) (Rep. Kemp noting that a proposal to allow the dependency exemption only against bottom bracket income converts the exemption to a credit); Peter Gottschalk, *Deductions Versus Credits Revisited*, 29 Nat'l Tax J. 221, 226 n.5 (1976); Seltzer, note 84, at 142.

<sup>203</sup> "Even if the view is taken that a child tax credit effectively offsets tax paid at the bottom marginal rate on essential income brought into the tax base, those claiming the credit still move up the marginal rate schedule faster than those without dependents." Sayeed, note 68, at 981.

## 2. *Credit Refundability*

An important design issue for any child tax credit is refundability. Recent child credit proposals have been of both the refundable<sup>204</sup> and nonrefundable<sup>205</sup> varieties.<sup>206</sup> Refundable credits are usable only to offset income tax liability, while nonrefundable credits would entitle parents to a check from the government if the credit exceeded the tax. It is hard to see any reason that a child credit intended as a subsidy should not be refundable,<sup>207</sup> particularly because the arguments for a child subsidy are nontax arguments.<sup>208</sup> Whether the purpose of the credit is to protect children's basic welfare needs or to encourage parents to invest more in their children, the subsidy would be *most* important where income was so low that the subsidy exceeded tax liability.<sup>209</sup>

If the credit were refundable, however, it would cease to be a part of the tax system in any substantive sense. Unlike a nonrefundable credit, the amount of which is limited by the tax liability, a refundable credit has no connection to a parent's tax liability. Congress may find it administratively convenient to let the Service administer the child

<sup>204</sup> Beyond Rhetoric, note 34, at 80; Steuerle & Juffras, note 34, at 3.

<sup>205</sup> The \$300 credit nearly enacted in 1992 would have been nonrefundable. H.R. 4210, note 7, § 23(c). An interesting variation on this theme comes from a Heritage Foundation proposal for a credit that could be used to offset Social Security tax liability as well as income tax liability, but otherwise would be nonrefundable. Heritage Foundation, note 37, at 12.

<sup>206</sup> Another possibility, suggested by Rep. Schroeder, would be to make child tax allowances nonrefundable but to let low income parents with unusable allowances sell them to high income taxpayers who could use them. Tax Policy Hearings, note 70, at 13. This approach is analogous to safe harbor leasing, which allowed loss corporations to sell depreciation deductions and investment tax credits to profitable corporations. Staff of Joint Comm. on Tax'n, 97th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 45-67 (Comm. Print 1983) (describing both the safe-harbor leasing rules and their repeal). However apt the analogy may have seemed to Rep. Schroeder, allowing the sale of excess child tax allowances is a terrible idea. Compared to simply making the allowances refundable, it would involve greater transaction costs and would result in some of the subsidy being captured by the high income purchasers rather than the low income parents.

<sup>207</sup> By its nature, a dependency exemption can only reduce or eliminate tax liability. It cannot result in a net cash flow from the government to the parent. Since the exemption is intended only to adjust positive tax liabilities for different abilities to pay, and not as a subsidy, this result is sensible.

<sup>208</sup> The Heritage Foundation proposal for a nonrefundable credit does not explain why the amount of the credit should not exceed combined income tax and Social Security tax liabilities. See Heritage Foundation, note 32, at 12. The proposal may reflect a strong moral (rather than economic) belief in the distinction between tax relief and government grants. One whose political philosophy disfavored taxation and government spending might see a tremendous difference between the last dollar of tax relief and the first dollar of grant, even though both dollars would look the same to an economist.

<sup>209</sup> Congressional acceptance of this reasoning is reflected in the refundability of the child-sensitive EITC. IRC § 32; see text accompanying notes 260-74.

subsidy, but substantively, the subsidy is entirely outside the tax system.<sup>210</sup>

### 3. *Credit Phaseouts*

A child tax credit should be phased out as family income increases. If the purpose of the credit is to ensure that the basic welfare needs of children are provided for, the credit is not needed in higher income families. If the purpose is to encourage parents to make socially beneficial investments in the upbringing of their children, the effect of the credit at higher income levels would be too trivial to justify the revenue cost.<sup>211</sup> Phaseouts are a common feature of child tax credit proposals. The proposed \$300 credit nearly enacted in 1992 was phased out in the middle income range,<sup>212</sup> and the recently enacted Canadian child tax credit is fully phased out (for a one- or two-child family) when family income reaches approximately \$67,000.<sup>213</sup> Even the House Republicans' "Contract with America" denies its \$500 credit to high income (over \$200,000) families.<sup>214</sup> However, one of the most prominent recent credit proposals—the \$1,000 credit conceived by Steuerle and Juffras and adopted by the National Commission on Children<sup>215</sup>—does not include a phaseout.<sup>216</sup> The credit would replace, rather than supplement, the dependency exemption.<sup>217</sup> Surpris-

<sup>210</sup> This statement is true for a flat refundable credit, which is not taxable and is not phased out as parental income increases. Taxing credits is discussed in the text accompanying notes 232-38; phasing out credits is discussed in the text accompanying notes 211-31.

<sup>211</sup> The objection to a continuing (not phased out) credit is not that it is regressive, but simply that it is an expensive subsidy where none is needed. Assuming a continuing credit is financed out of general revenue raised by a proportional income tax and that family size does not increase proportionately with income, the net effect will be progressive. Jonathan R. Kesselman, *Income Security via the Tax System: Canadian and American Reforms*, in *Canada-U.S. Tax Comparisons* 97, 138 (John B. Shoven & John Whalley eds., 1992) [hereinafter *Income Security*]. Redistribution of income from high income families to large families tends to equalize income distribution. Of course, the effect of a phased out credit would be even more progressive.

<sup>212</sup> H.R. 4210, note 7, § 23(c). The phaseout range was between AGI of \$50,000 and \$70,000. Another proposal for a phased out child tax credit is set forth in Jonathan B. Forman, *Beyond President Bush's Child Tax Credit Proposal: Towards a Comprehensive System of Tax Credits to Help Low-Income Families with Children*, 38 *Emory L.J.* 661, 693-97 (1989).

<sup>213</sup> *Income Tax Act*, R.S.C., ch. 48, §§ 122.6-.64, amended by ch. 63, 1970-1972 S.C. § 122.2, and as subsequently amended (Can.); see Jonathan R. Kesselman, *The Child Tax Benefit: Simple, Fair, Responsive?*, 19 *Can. Pub. Pol'y* 109, 111 (1993) [hereinafter *Child Tax Benefit*].

<sup>214</sup> H.R. 6, note 38, § 2(a).

<sup>215</sup> Steuerle & Juffras, note 34; *Beyond Rhetoric*, note 34, at 80.

<sup>216</sup> The Report of the National Commission notes, however, that some of the Commissioners favored limiting the credit to families with incomes under \$150,000. *Beyond Rhetoric*, note 34, at 109-10.

<sup>217</sup> Steuerle & Juffras, note 34, at 16-17.

ingly, Steuerle and Juffras claim that “[t]hose with equal needs are served equally” under a proposal to grant the same \$1,000 per child credit to rich and poor families alike.<sup>218</sup> Given the prominence of this proposal, the arguments for not phasing out the credit merit careful examination.

Steuerle and Juffras defend the absence of a phaseout on the grounds that the proposal “adjust[s] income tax liability adequately for family size at all income levels.”<sup>219</sup> This is a tax-internal argument, rather than a subsidy argument. It ignores the fact that an exemption is clearly superior to a credit as a means of reflecting differences in ability to pay due to differences in family size.<sup>220</sup> Their choice of credits over exemptions based on a subsidy analysis<sup>221</sup> appears inconsistent with their reversion to an ability to pay analysis to justify not phasing out the credits.

A possible explanation exists for the apparent inconsistency, however. The amount of a continuing credit could be set to equal the tax savings that would be realized by parents in the highest tax bracket from an exemption equal to the cost of their child’s subsistence. Thus, the credit would serve as an exemption equivalent in the highest bracket (producing appropriate differences in tax liability based on family size differences in ability to pay) and as an exemption equivalent plus a subsidy in all lower brackets. The lower the bracket, the smaller the amount of the credit serving as an exemption equivalent and the larger the amount serving as a subsidy. Steuerle and Juffras never indicated, however, that this interpretation is what they have in mind. In any event, it requires that a child subsidy be granted to every family not in the top rate bracket. Under current law, this credit would have the indefensible effect of subsidizing every family with taxable income below \$250,000.<sup>222</sup> If the credit were made smaller to avoid this effect, it would not serve as a full exemption equivalent for the highest bracket taxpayers.

Perhaps realizing the weakness of the ability to pay defense, Steuerle and Juffras offer an additional reason for not phasing out the credit: concern over the high marginal tax rates that a phaseout would impose on “individuals who barely remove themselves from poverty

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<sup>218</sup> Id. at 8.

<sup>219</sup> Id. at 20.

<sup>220</sup> See-text accompanying notes 59-73.

<sup>221</sup> Steuerle has stated elsewhere that his preference for credits over exemptions is based on the greater assistance credits provide to lower income parents. *Reclaiming the Tax Code*, note 35, at 105 (statement of Eugene C. Steuerle). Similarly, the National Commission on Children favored a credit system partly because an exemption system “provides a greater benefit to families with higher earnings.” *Beyond Rhetoric*, note 34, at 94.

<sup>222</sup> See IRC § 1(a), (b).

or welfare.”<sup>223</sup> This is certainly a legitimate concern, but addressing it does not require child tax subsidies for millionaires. The phaseout could begin somewhere in the middle income range, rather than just above the poverty level.<sup>224</sup> In addition, the phaseout could be spread over a wide income range, so that it never constitutes an increase of more than five or 10 percentage points in the marginal tax rate. To avoid the imposition of higher marginal tax rates on larger families,<sup>225</sup> the system could phase out the credit for each child sequentially rather than simultaneously.<sup>226</sup>

A final argument for a universal credit—although only briefly alluded to by Steuerle and Juffras—is that it “avoids the stigma of ‘welfare.’”<sup>227</sup> The high income phaseout of exemptions under current law<sup>228</sup> has not stigmatized parents who are entitled to dependency exemptions. As long as the benefit is available to a broad segment of the middle class, a middle-income phaseout—such as the new Canadian credit or the proposed 1992 legislation—would not impose any stigma on the recipients.<sup>229</sup> Even the earned income tax credit does not seem to brand its recipients, despite being targeted at low income earners.<sup>230</sup>

Despite the legitimate concerns regarding a phaseout, the real explanation for the proposal of a universal child subsidy may have more to do with its political appeal. If so, universality may be an expensive way of buying the necessary political support for the subsidy.<sup>231</sup>

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<sup>223</sup> Steuerle & Juffras, note 34, at 19.

<sup>224</sup> This type of phaseout was the approach of the 1992 legislation described in the text accompanying note 36; see note 212.

<sup>225</sup> That is the effect of the phaseout of exemptions under current law as explained in the text accompanying note 80.

<sup>226</sup> Forman, note 212, at 695, suggests this approach.

<sup>227</sup> Gravelle, note 54, at 15; Steuerle & Juffras, note 34, at 8.

<sup>228</sup> The phaseout system is described in the text accompanying notes 74-87.

<sup>229</sup> Student loans are one example of a government subsidy that is income tested, yet avoids imposing a stigma. Alfred J. Kahn, *Financial Help for Vulnerable Families: The Income Transfer Menu*, in *Tax Policy: How Do Families Fare*, Report of House Select Comm. on Children, Youth and Families, 99th Cong., 1st Sess. 137, 150 (Comm. Print 1985) [hereinafter *Family Tax Policy Report*]. The explanation may be that the program benefits many members of the middle class.

<sup>230</sup> The EITC may be a special case. Perhaps it can target low incomes without imposing a stigma only because its availability is directly tied to the earning of income.

<sup>231</sup> The small departure from universality resulting from a phaseout at very high income levels probably has little political effect—consider the existence of the current phaseout of exemptions. See IRC § 151(d)(3). It also, however, does little to lessen the revenue cost of the benefit. The National Commission on Children estimated that limiting the \$1,000 per child credit to families with incomes under \$150,000 would only reduce the revenue cost of the credit from \$40.3 billion to \$39.2 billion. *Beyond Rhetoric*, note 34, at 109-10.

#### 4. *Taxing Credits and Combining Credits with Exemptions*

Parents who receive \$1,000 in the form of a child tax credit subsidy have an increased ability to pay income tax, just as if they had received \$1,000 from any other source. This suggests that the amount of a child tax credit itself should be included in taxable income.<sup>232</sup> Although most recent proposals have been for tax-free child tax credits, taxable credits also have been proposed<sup>233</sup> and have been used outside the United States.<sup>234</sup> A nontaxable child tax credit is the equivalent of including the credit in income, but allowing a dependency exemption equal to the amount of the credit. Therefore, the question of the taxability of the credit is best examined by considering the merits of allowing parents both a child tax subsidy and a dependency exemption.<sup>235</sup>

A child credit often is proposed as an addition to, rather than as a replacement for, the dependency exemption.<sup>236</sup> Although political expediency may be the explanation for many add-on credit proposals, combining exemptions and credits can be defended on principle. One can reasonably believe both that the tax system should adjust (through exemptions) for family size differences in ability to pay, and that parental spending on children is so important (for child welfare, for the future of society or both) that it should be subsidized (through credits).<sup>237</sup> The combination would be analogous to allowing a business both depreciation deductions (reflecting ability to pay) and an

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<sup>232</sup> For a familiar example of a tax subsidy affecting the determination of taxable income, see former IRC § 48(q)(1) (before repeal in 1986), which required taxpayers to decrease the basis of depreciable property by one-half the investment tax credit allowed on the property. (Since the cost to the taxpayer of the property was reduced by the entire amount of the credit, a basis reduction of the entire amount of the credit would have been more logical.)

<sup>233</sup> Family Tax Policy Report, note 229, at 149.

<sup>234</sup> Until the recent legislation described in note 213, Canada provided family allowances (the equivalent of refundable child tax credits) that were taxable to higher income parents. The allowances also were phased out as parental income increased. Only the portion of the allowance that had not been phased out was taxable. Kesselman, *Income Security*, note 211, at 107-08, 135-39.

<sup>235</sup> This discussion goes to the merits of adopting both an explicit credit intended solely as a subsidy and an explicit exemption intended solely as a tax-internal provision. An explicit credit and no explicit exemption, with the credit designed to serve both as a subsidy and an exemption equivalent, is a different concept. See text accompanying note 222.

<sup>236</sup> See text accompanying notes 36-38. The combination of exemption and credit is not unknown in the Code's history. The Tax Reform Act of 1976, Pub. L. No. 94-455, § 401, 90 Stat. 1520, 1555, provided for a temporary \$35 per person tax credit in addition to the existing \$750 exemption. See Staff of Joint Comm. on Tax'n, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976*, at 111-14 (Comm. Print 1977) [hereinafter 1976 Bluebook].

<sup>237</sup> Michael J. McIntyre, *Implications of Family Sharing for the Design of an Ideal Personal Tax System*, in *The Personal Income Tax: Phoenix from the Ashes* 145, 157 (Sijbren Cnossen & Richard M. Bird eds., 1990) ("Of course, the case for a [child] credit on tax



investment credit (a subsidy) for the same asset.<sup>238</sup> In short, the income rationale for exemptions would persist even if a child tax credit were enacted.

A child credit should be taxable, because it increases ability to pay, but it should not replace (or decrease the size of) a subsistence-level exemption. On the other hand, it should not increase the exemption either. If the amount of the stated exemption has been set correctly at the subsistence level, but then is supplemented by the additional exemption implicit in the nontaxability of the credit, the exemption level will be too large by the amount of the credit. The appropriate adjustment, if the credit is to remain nontaxable, is to reduce the stated exemption by the amount of the credit. Elimination of the stated exemption on account of the enactment of a nontaxable credit would be appropriate only in the unlikely case of a credit equal to the full cost of subsistence. If the credit is for less than the full cost of subsistence, the exemption implicit in the nontaxability of the credit will be less than the appropriate exemption amount, and the stated exemption should be reduced but not eliminated.

### C. *Population Policy and Child Tax Allowances*

The income tax treatment of children can be manipulated to further population policy by encouraging or discouraging fertility. Explicitly pronatalist tax policies are in use in a few countries. The French family income splitting formula treats the third and later children more favorably than the first two in order to encourage larger families.<sup>239</sup> Although Congress has never claimed to use the tax treatment of children to influence fertility, serious proposals for both antinatalist and pronatalist tax policies have been made in the United States.

In 1970, Senator Packwood introduced a bill to allow dependency exemptions for only the first two children<sup>240</sup> with the stated purpose of discouraging large families.<sup>241</sup> One commentator thought the Packwood proposal was too weak and suggested abolishing all depen-

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expenditure grounds does not in any way discredit the case for a dependency allowance on tax policy grounds.”).

<sup>238</sup> The combination of depreciation and the investment tax credit under former law is discussed in note 232.

<sup>239</sup> Pechman & Engelhardt, note 110, at 9. The splitting formula assigns only one-half as much income to each of the first two children as to an adult, but additional children are assigned as much income as an adult. In addition to permitting family income splitting, France provides substantial cash grants for children. The only explicitly pronatalist North American tax policy is in Quebec, which provides a child tax credit much larger than the federal allowance in the hopes of encouraging growth of the Francophone population. Kesselman, *Income Security*, note 211, at 108.

<sup>240</sup> S. 3632, 91st Cong., 2d Sess. (1970).

<sup>241</sup> Bob Packwood, *Incentives for the Two-Child Family*, 6 *Trial*, Aug./Sept. 1970, at 13.

dency exemptions or (if even that proved inadequate) an income tax surcharge on children.<sup>242</sup> More recently, Ben Wattenberg has made a case for a pronatalist federal policy with an income tax component.<sup>243</sup> He suggests approximately doubling the dependency exemption for all children under 16 or granting new benefits only to families with three or more children.<sup>244</sup>

Using the income tax as a tool of population policy is not a good idea—certainly not now and probably not ever—for several reasons. First, the current total fertility rate (“TFR”) is so close to replacement level that it is difficult to make a case for the existence of any sort of population crisis.<sup>245</sup> Whether one’s great fear is population explosion or decline, it is hard to find anything drastically wrong with a TFR so near replacement level.<sup>246</sup>

What if the TFR were to move significantly above or below replacement level? Opinion polling indicates that most people fear population growth.<sup>247</sup> Wattenberg and other pronatalists, however, may be able to convert substantial numbers to his view that greater harm

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<sup>242</sup> Edward H. Rabin, *Population Control Through Financial Incentives*, 23 *Hastings L.J.* 1353, 1366-72 (1972).

<sup>243</sup> Wattenberg, note 187.

<sup>244</sup> *Id.* at 151. He also suggests bypassing the tax system and simply making a substantial cash grant for every child born after some specified date. *Id.* at 152. Such a grant system is substantively indistinguishable from a refundable child tax credit. See text accompanying note 210.

<sup>245</sup> The TFR for a given year is the number of births 1,000 women would have in their lifetimes if at each year of age they matched the birthrate for women of that age in the given year. The replacement level TFR is 2,110. It may seem that the replacement level TFR would be exactly 2,000 (1,000 married couples would replace themselves if they had 2,000 children). The slightly higher figure is due to childhood deaths and the higher male birth rate. Wattenberg, note 187, at 22.

The fertility rate for 1992 was 2,054, and the Census Bureau projects a rate of 2,092—almost equal to replacement level—by the year 2010. See *Census Abstract*, note 130, at 76 tbl. 96. Actually, the 1992 TFR is itself a projection. The last year for which an actual TFR (2,014) is given is 1989. *Id.* at tbl. 95.

<sup>246</sup> In recent decades, the TFR has had an interesting habit of correcting itself when it has strayed far enough from replacement level to worry some people. In 1969, President Nixon championed an antinatalist policy (which did not include an income tax component) in response to an above replacement level TFR. Paul Demeny, *Pronatalist Policies in Low-Fertility Countries: Patterns, Performance and Prospects*, in *Below-replacement Fertility in Industrial Societies* 335, 337 (Kingsley Davis, Mikhail S. Bernstam & Rita Ricardo-Campbell eds., 1987) [hereinafter *Replacement Fertility*]. In 1972, a presidential commission recommended various policies to decrease the TFR, but by then the TFR already had dropped below replacement level. *Id.* Ben Wattenberg’s pronatalist polemic, Wattenberg, note 187, was inspired by TFRs around 1,800 in the early and mid-1980’s, but now the TFR has risen almost to replacement level. See note 245.

<sup>247</sup> A 1992 Roper Poll found that 34% of those surveyed thought the United States should start thinking now about ways to control population growth, and 52% thought a major population problem requiring immediate attention already existed. *American Attitudes Toward Immigration*, Accession 0178771, Question 009, July 9, 1992, available in LEXIS, Nexis Library, RPOLL File.

would result from a declining population.<sup>248</sup> In the absence of a consensus on the costs and benefits of population growth and decline, even a clear trend would not warrant government intervention.

Even if there were consensus that the government should counteract population trends, intervention through the tax system still would be objectionable for two reasons. First, antinatalist intervention would threaten the integrity of the income tax. If a tax based on ability to pay should adjust for family size, then an antinatalist denial of family size adjustments would undermine the structure of the tax.<sup>249</sup> This problem may sound like one about which only a tax policy wonk could get excited, but opinion polling suggests broader public interest. In a 1985 Roper poll, 72% of those surveyed opposed limiting the dependency exemption to the first two children in order to discourage fertility,<sup>250</sup> notwithstanding that most of those surveyed believed the government should take some action to control population growth.<sup>251</sup> Although these results can be interpreted in various ways, it is plausible that the public has an intuitive sense of the tax policy justification for dependency exemptions and does not want to sacrifice tax policy to population policy.<sup>252</sup>

Pronatalist tax provisions would be less of a threat to the tax structure, since they readily could be combined with appropriate ability to pay-family size adjustments.<sup>253</sup> They would be subject, however, to the second, and more important, objection. It is unlikely that any tax changes motivated by population policy would exert significant influence on fertility. This concern that the changes would not work is especially serious for pronatalist changes, because of the great potential expense of child tax subsidies.

The idea behind pronatalist tax proposals is not that the subsidies would be large enough to make having a child a profitable venture,

<sup>248</sup> His list of the problems caused by a declining population include: (1) the dispiriting effects of living in an aging society, Wattenberg, note 187, at 71-72, (2) decreasing incentive for technological innovation, *id.* at 72-74, (3) difficulty in financing Social Security, *id.* at 67-71, and (4) decreasing American geopolitical and geocultural influence, *id.* at 79-87.

<sup>249</sup> This is the theme of Schaffer & Berman, note 84.

<sup>250</sup> Roper Report 85-6, Accession 0125768, Question 069, Sept. 1985, available in LEXIS, Nexis Library, RPOLL File.

<sup>251</sup> Only 26% of those surveyed favored doing nothing to control population. *Id.* at Accession 0125773, Question 074.

<sup>252</sup> Another interpretation is that those surveyed doubt the efficacy of the denial of dependency exemptions in reducing fertility. The two explanations are not mutually exclusive.

<sup>253</sup> See text accompanying notes 232-38. Just as an exemption and a pronatalist tax credit could be viewed as a combination of an ability to pay adjustment and a tax expenditure, an antinatalist tax system could be viewed as combining an ability to pay adjustment and a reverse tax expenditure—with the latter cancelling out the former. As a matter of cold logic, this view makes some sense, but a pronatalist tax system includes an adequate (actually, more than adequate) family size adjustment and an antinatalist tax does not.

but only that they would be large enough to make children affordable to people who would like to have them but are not doing so currently because of the cost.<sup>254</sup> Even where pronatalist tax policies are in force, it is impossible to be certain of their influence on fertility. Many other factors influence child-bearing choices, and performing an experiment by offering tax incentives only to a control group is not feasible. One scholar reviewing the literature on the effect of financial incentives on fertility concluded that incentives may have a temporary effect on the timing of births, but do not influence ultimate family size.<sup>255</sup> Another scholar concluded that the modal finding in the relevant literature is that the population effects of pronatalist incentives are nil or negligible.<sup>256</sup>

The main problem in designing a cost-effective pronatalist incentive is “buying the base”—paying expensive rewards to parents for children that they would have had without the incentive. There is no practical way of identifying those children and denying the rewards to their parents.<sup>257</sup> As a result, one expert has estimated that increasing the dependency exemption by \$2,000 would cost \$19 billion and produce 19,000 additional children—at a cost of \$1 million per child.<sup>258</sup> Another expert has stated that the cost of an effective pronatalist tax policy might be on the order of magnitude of the defense budget.<sup>259</sup>

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<sup>254</sup> A possible secondary effect is that, quite apart from practical economic concerns, potential parents will be swayed by the symbolism of pronatalist tax policy—by the message that having children is a good thing to do. The symbolic effect of tax-based population policy is cited more frequently by proponents of antinatalism. Bittker, note 51, at 1449 (suggesting that an antinatalist message could be sent, without too much damage to the ability to pay concept, by denying exemptions for “excess” children for only one or two years); Rabin, note 242, at 1371.

<sup>255</sup> C. Allison McIntosh, *Recent Pronatalist Policies in Western Europe*, in *Replacement Fertility*, note 246, at 318, 323.

<sup>256</sup> Demeny, note 246, at 350. Wattenberg acknowledges that this is the opinion of most experts, but cites evidence of effective pronatalist financial incentives in some Eastern European communist countries. Wattenberg, note 187, at 140-42. Financial incentives that might be sufficient to induce additional fertility in very poor countries might have little effect, however, in an affluent nation.

<sup>257</sup> Paying rewards only for children beyond the first two might avoid some buying of the base, but it is obviously both over- and under-inclusive. That is, some people would have many children even without the reward, and some people would choose to have a first or second child only if a reward was offered.

<sup>258</sup> Wattenberg, note 187, at 188 (citing statement of Thomas Esperishade, reported by the *S.F. Chron.*, Aug. 13, 1987).

<sup>259</sup> Demeny, note 246, at 353. Demeny mentions an additional problem. To the extent they have any effect, tax fertility incentives will be most influential at lower income levels. Encouraging increased fertility primarily among those who can least afford it is dubious public policy. “A Singapore-style solution . . . granting fertility-stimulating material incentives to families belonging to higher socioeconomic strata—would require a Singapore-style political system.” *Id.*

## V. BEYOND THE BASIC CHILD ALLOWANCE

Until this point, the Article has concentrated on the basic child tax allowance—whether exemption, credit or both. The Article now turns to the question of tax allowances for children under special circumstances and considers the EITC, head of household status and the child care credit.

A. *The Earned Income Tax Credit*

The EITC raises a number of important policy issues.<sup>260</sup> Consideration here is limited to the question of how the EITC should adjust for family size. A childless low income wage earner is allowed only a small EITC, equal to 7.65% of the first \$4,100 of earned income.<sup>261</sup> This credit serves as a refund of the employee's portion of the payroll tax on the first \$4,100 of earnings.<sup>262</sup> With the addition of a dependent child, the credit percentage increases dramatically (to 34%) and the earnings eligible for credit increase moderately (to \$6,160).<sup>263</sup> A second dependent child results in moderate increases in both the credit percentage (to 40%) and eligible earnings (to \$8,640).<sup>264</sup> Additional children beyond the second have no effect on the credit. There are two important issues relating to the effect of the number of dependent children on the amount of the EITC. One is whether it is reasonable for the increase in the amount of the credit to be so large for the first child, much smaller for the second child and nonexistent for all additional children. The other is whether the family size adjustment should take the form of an increase in the credit percentage, in eligible earnings or both.

There are two possible explanations why the EITC grants no additional wage supplement on account of children beyond the first two,

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<sup>260</sup> For a discussion of the problems of using the EITC as part of welfare reform, see Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 Harv. L. Rev. 533 (1995). For recent discussions of EITC design issues, see Jonathan B. Forman, *Expanding the Earned Income Credit to Help the Working Poor*, 40 Tax Notes 851 (Aug. 22, 1988); Michael W. Mills, *A Move Toward Responsible Capitalism: Extending and Modifying the Earned Income Tax Credit*, 24 Rutgers L.J. 571 (1993); George K. Yin, John K. Scholz, Jonathan B. Forman & Mark J. Mazur, *Improving the Delivery of Benefits to the Working Poor: Proposals to Reform the Earned Income Tax Credit Program*, 11 Am. J. Tax Pol'y 225 (1994).

<sup>261</sup> IRC § 32(b)(1)(A), (2)(A); Rev. Proc. 94-72, note 8, at 16.

<sup>262</sup> See H.R. Rep. No. 111, note 83, at 609, reprinted in 1993-3 C.B. 180 ("extending the EITC to low-income working taxpayers without qualifying children will . . . reduce the burden of . . . payroll taxes on those with a lower ability to pay taxes"). The employee's portion of the payroll tax is 7.65%. IRC § 3101(a), (b).

<sup>263</sup> IRC § 32(b)(1)(A), (2)(A); Rev. Proc. 94-72, note 8, at 16.

<sup>264</sup> *Id.* The 40% credit percentage is effective for tax years beginning after 1995. The workings of the credit are described in more detail in text accompanying notes 14-17.

despite the apparent need of larger families for larger credits. The first is an anomaly in the legislative process. The distributional tables used by Congress in determining how proposed tax changes affect different income groups are based on households or tax filing units, without regard to family size.<sup>265</sup> This makes larger families appear to be better off than they are and masks the progressivity of tax relief targeted at larger families. According to former Treasury Deputy Assistant Secretary for Tax Policy Michael Graetz, the 1990 EITC amendments would have been more favorable to large families, but for the fact that the distributional table indicated large families were better off than they really were.<sup>266</sup> It is a shame if large low income families have not received adequate wage supplements because Congress is heavily influenced by distributional tables and it is not convenient to reflect family size in those tables.<sup>267</sup>

There is, however, another possible explanation: that Congress believes that low income workers should not have more than two children, or at least if they do have more than two children, they should pay for them without help from the government. Congress has never actually said this, but Gary Bauer of the conservative Family Research Council has testified before Congress that EITC limitations on family size are justifiable for cash transfer recipients who are not yet self-sufficient.<sup>268</sup> Bauer at least deserves credit for having the courage to state clearly such a controversial position. Congress should do the same. If it is limiting EITC adjustments to two children out of a belief that the working poor have no business having more than two children, it should say so. If it is unwilling to say so, it should increase EITC benefits for larger families.

If Congress chose to make the EITC more favorable to larger families, it could do so by making family size adjustments to the credit percentage, to eligible wages or to both. The current system does both for the first two children. Strangely, the increase in the credit percentage is the major change caused by the first child, but the in-

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<sup>265</sup> Staff of Joint Comm. on Tax'n, 103d Cong., 1st Sess., *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* 13, 97-99 (Comm. Print 1993) [hereinafter *Tax Burdens*]; Gene Steuerle, *Are Children Mistreated by Tables on the Distribution of Income?*, 56 *Tax Notes* 369 (July 20, 1992) [hereinafter *Distribution Tables*].

<sup>266</sup> Steuerle, *Distribution Tables*, note 265, at 370 (attributing story to Graetz). The 1990 EITC amendments grew out of the House version of the Omnibus Budget Reconciliation Act of 1989, H.R. 3299, which had provided for an increased credit percentage for a third child. H.R. Rep. No. 386, 101st Cong., 1st Sess. 680 (1989) (Conf. Rep. to accompany H.R. 3299). The 1990 amendments, however, contained no third-child adjustment. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11111, 104 Stat. 1388, 1388-408.

<sup>267</sup> "The tax filing unit has been chosen as the unit of [distributional] analysis primarily because of data availability." *Tax Burdens*, note 265, at 13.

<sup>268</sup> See Bauer Statement, note 35, at 60.

crease in eligible wages is the more significant for the second child.<sup>269</sup> Jane Gravelle has argued that under ability to pay analysis, the EITC credit percentage should not vary by family size, but that the amount of eligible wages should increase with the number of children.<sup>270</sup> Her analysis is based on a family income splitting model of ability to pay, under which rate bracket widths should be adjusted for family size.<sup>271</sup> Thus, she thinks of the EITC as a negative tax bracket and reasons that larger families should benefit from wider negative brackets, just as they should benefit from a wider zero bracket and wider low rate positive brackets. This argument will appeal only to those who already have accepted the basic premise that ability to pay mandates an income splitting approach.

A more fundamental objection to the Gravelle approach is that it pays too little attention to the question of why the EITC should adjust for family size at all. The attraction of the EITC is that it offers a more efficient way of raising families out of poverty than increasing the minimum wage, because the minimum wage cannot adjust for an earner's family responsibilities, but the EITC can.<sup>272</sup> EITC family size adjustments are best understood as wage supplements for family responsibilities.<sup>273</sup>

Suppose Congress were to make a commitment that the EITC would be sufficient for any parents who work full time at the minimum wage to earn enough—counting both the wages and the EITC supplement—to support themselves and their children at a subsistence level.<sup>274</sup> Suppose also that the full time annual minimum wage is \$10,000, which equals the subsistence cost of a single person without children.<sup>275</sup> Finally, suppose adding one child to the worker's household increases the family subsistence level to \$12,000, and adding a second child increases the level to \$14,000. A childless worker earning \$10,000 should pay no taxes (because she has no above-subsistence income), but should also receive no EITC (because of the absence of

<sup>269</sup> See IRC § 32(b).

<sup>270</sup> Gravelle, note 54, at 20.

<sup>271</sup> *Id.* at 13. The income splitting model is discussed in Section II.C.

<sup>272</sup> Kamarck & Galston, note 39, at 27. Congress has acknowledged this purpose of the EITC: "Providing a larger basic EITC to larger families recognizes the role the EITC can play in alleviating poverty." H. Rep. No. 111, note 83, at 609, reprinted in 1993-3 C.B. at 180.

<sup>273</sup> Under this theory, there would be no need for any EITC for a worker without dependents, because the minimum wage would be set at a level sufficient to satisfy the subsistence needs of that worker. The small EITC for a childless worker has a different explanation—it functions as a refund of the payroll taxes on the first \$4,100 of earnings. See note 262.

<sup>274</sup> For simplicity of illustration, the example assumes that subsistence wages are not reduced below subsistence by the Social Security wage tax.

<sup>275</sup> All dollar figures in the example are solely for illustration.

dependents). To achieve the wage supplement objective for a minimum wage earner with one child, the worker should receive a \$2,000 EITC: 20% of \$10,000, reflecting the fact that the family's subsistence costs are 20% greater than those of a childless worker. The \$10,000 earnings and the \$2,000 credit together will cover subsistence needs. A two-child wage earner should receive a \$4,000 credit: 40% of the same \$10,000 earnings. Adjusting the credit percentage for family size is the only way to achieve this goal. The Gravelle approach would not do so. Telling the worker with two children that she would have been entitled to a credit on more than \$10,000 earnings from full time work does her no good; worse, it mocks her.

### *B. Head of Household Status*

The first dependent of an unmarried taxpayer confers two tax benefits not conferred by any other dependent. The first dependent makes the taxpayer a head of household, entitling her to a more favorable rate schedule<sup>276</sup> and a larger standard deduction<sup>277</sup> than those applicable to singles without dependents. No child of a married couple, and no additional child of a single person, has any effect on either the rate schedule or the standard deduction. What makes this child so special?

The explanation involves more history than logic. In 1948, Congress provided for automatic income splitting between spouses.<sup>278</sup> Under this system, a couple's income was combined, and then taxed under a rate schedule with brackets twice as wide as the schedule for single persons. The couple's tax liability was the same as that of two single people, each with half the couple's income. Although this tax advantage was not premised on the existence of children, single parents viewed it as an allowance for family responsibilities and claimed they were entitled to similar consideration.<sup>279</sup> They prevailed in 1951, when Congress introduced the head of household filing status.<sup>280</sup> By providing for a larger standard deduction and wider brackets, head of household status granted single parents some (but not all) of the income splitting benefit enjoyed by spouses.<sup>281</sup>

<sup>276</sup> The 15% bracket is \$31,250 wide for heads of household, and only \$23,350 wide for other unmarried taxpayers. The 28% bracket covers \$51,500 of taxable income for heads of households, and only \$33,200 for other unmarried taxpayers. IRC § 1(b), (c); Rev. Proc. 94-72, note 8, at 16.

<sup>277</sup> The standard deduction for a head of household is \$5,750; for other unmarried taxpayers, it is \$3,900. IRC § 63(c)(2); Rev. Proc. 94-72, note 8, at 3.

<sup>278</sup> Revenue Act of 1948, Pub. L. No. 80-471, §§ 301-305, 62 Stat. 110, 114-16.

<sup>279</sup> Bittker, note 51, at 1417.

<sup>280</sup> Revenue Act of 1951, Pub. L. No. 82-183, § 301, 65 Stat. 452, 480.

<sup>281</sup> See McIntyre & Oldman, note 104, at 1602 (suggesting head of household status can be viewed as permitting partial income splitting with a phantom spouse).



Although critics have claimed there is no principled justification for the special tax status of head of household,<sup>282</sup> it continues to enjoy the support of Congress. In 1986, Congress narrowed the gap between the head of household standard deduction and the married couple's standard deduction, on the grounds that "the costs of maintaining a household for an unmarried individual and a dependent more closely resemble the situation of a married couple than that of a single individual without children."<sup>283</sup> More recently, there has been support for further improving the tax treatment of heads of households, by letting them use the same rate schedule as married couples.<sup>284</sup>

### 1. *Wider Brackets*

The two aspects of head of household status—wider brackets and a larger standard deduction—require separate consideration. The wider brackets amount to a family income splitting formula for a single parent and her first dependent. Although a strong case can be made on ability to pay grounds for formula income splitting between parents and children,<sup>285</sup> current law does not allow it in any other situation. As long as the law generally does not permit formula income splitting with children, there is no reason to make an exception for the first child of a single parent. That exception cannot be justified by pointing to the income splitting allowed between spouses.<sup>286</sup> Congress decided that the income of spouses should be combined to tax the spouses as a single economic unit and impose equal tax on equal in-

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<sup>282</sup> See, e.g., Glenn E. Coven, *The Decline and Fall of Taxable Income*, 79 Mich. L. Rev. 1525, 1537 n.52 (1981) (calling the status "an arbitrary rate reduction devoid of factual support").

<sup>283</sup> S. Rep. No. 313, note 60, at 36, reprinted in 1986-3 C.B. (vol. 3) at 36.

<sup>284</sup> Kamarck & Galston, note 39, at 25 ("Single-parent families have nothing in common with single people and everything in common with other families" (quoting the claim of Lawrence Lindsey, *The Growth Experiment* 223 (1990))).

<sup>285</sup> See Section II.C.

<sup>286</sup> The income splitting allowed to spouses under current law is not as generous as the 1948 legislation described in the text accompanying note 278. In 1969, Congress changed the relationship between the tax rates applicable to joint returns of married couples and the rates applicable to unmarried taxpayers without dependents. Tax Reform Act of 1969, Pub. L. No. 91-172, § 803, 83 Stat. 487, 678. Under the approach of the 1969 legislation, which is also the approach of current law, the rate brackets for married couples are wider than those for single taxpayers, but less than twice as wide. IRC § 1(a), (c). A married couple is taxed more heavily than two single persons, each with half of the couple's income. The couple is taxed less heavily, however, than a single person with the couple's combined income. The result is that a man and woman with roughly equal incomes will suffer a tax marriage penalty, and a man and woman with very unequal incomes will enjoy a significant tax marriage bonus. Zelenak, *Marriage*, note 63, at 339-41.

come couples.<sup>287</sup> Given this decision, either couples must be allowed some measure of formula income splitting (in the form of wider brackets), or there will be tremendous tax penalties for two-income married couples. Wider brackets for married couples are an attempt to alleviate a problem—tax penalties on marriage—that does not exist with respect to children. Thus, the formula income splitting permitted married couples provides no justification for splitting between a single parent and one child.

## 2. *Increased Standard Deduction*

### a. *Uniquely High Subsistence Costs?*

The \$1,850 increased standard deduction granted an unmarried taxpayer on account of her first child has an effect similar to allowing a larger dependency exemption (\$4,350 versus \$2,500) for the first child of an unmarried taxpayer than is allowed for any child of married taxpayers, or for any additional children of an unmarried taxpayer.<sup>288</sup> Are there uniquely high subsistence costs of such a child that justify this special allowance? The question cannot be answered definitively, because of a scarcity of studies on expenditures on children by single parents.<sup>289</sup> The best available information comes from a 1993 study by the Family Economics Research Group of the Department of Agriculture, based on data from the 1990 Consumer Expenditure Survey of the Bureau of Labor Statistics.<sup>290</sup> This study does compare expenditures on children by one- and two-parent families, considering variations both by income level and by family size. The study is not ideal for present purposes, however, because it does not attempt to estimate the cost of supporting children at subsistence, which is the crucial question for determining the appropriate size of exemptions. Rather, the study attempts to measure actual expenditures on children under different circumstances, without judging the adequacy of those expenditures. Despite this problem, information on the costs of children not far above subsistence can be gleaned by examining the data on expenditures on children in the lowest income category considered by the study.

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<sup>287</sup> This decision was not inevitable; each spouse could be required to file a separate return on the same basis as an unmarried taxpayer. For an extended argument that a separate filing system would be preferable, see Zelenak, *Marriage*, note 63.

<sup>288</sup> The basic difference between an increased standard deduction and a larger dependency exemption is in how each benefit is phased out as income increases. This difference is discussed in Section II.B.3.

<sup>289</sup> Child Support Guidelines, note 155, at II-36 ("There is, unfortunately, a dearth of data concerning expenditure patterns in single-parent households.").

<sup>290</sup> Child Expenditures, note 149.

According to the study, married couples with pretax income of less than \$32,000 (in 1993) spent an average of \$6,840 annually on an only child, and single parents in the same income range spent an average of \$7,243 on an only child.<sup>291</sup> Although this suggests that the only child of a single parent may be slightly more expensive than the only child of a married couple, the difference is slight compared to the difference in the tax allowances.<sup>292</sup>

If the special allowance for an only child of an unmarried taxpayer cannot be justified relative to the only child of a married couple, can it at least be justified relative to later children? Again, the answer is no. Although the study reports that, “[c]ompared with expenditures for each child in a single-parent, two-child family, single-parent households with one child spent approximately 37 percent more on the single child,”<sup>293</sup> this does not support a larger tax allowance for the first child. Greater per child expenditures in smaller families is a consistent phenomenon, regardless of the number of parents. There is nothing special in this respect about the first child of a single parent.<sup>294</sup> As long as exemption levels do not reflect this phenomenon in any other situation, there is no reason to reflect it here. Moreover, it is reasonable for subsistence-based exemption levels not to reflect decreasing expenditures on additional children, because the bulk of the decrease comes from children receiving smaller shares of discretionary family

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<sup>291</sup> *Id.* at 16 tbl. A, 22 tbl. G. The cited tables give expenditures on the younger child in a two-child family, differentiated by child age. The figures in the text were derived by first averaging the age-based expenditure figures, and then converting to expenditures on a single child by multiplying the result by a factor indicated in each table (1.26 for two-parent families and 1.37 for single-parent families). There is a problem in comparing the \$6,840 and \$7,243 figures, in that the average income of the two-parent families is considerably higher than the average income of the single-parent families (\$20,000 versus \$13,700). This suggests that, if the average incomes in the two groups were the same, child expenditures by single-parent families would substantially exceed those by two-parent families, thus supporting a larger exemption for the first child of a single parent. But that ignores the fact that there is an extra adult in the two-parent families. Under most equivalency scales, a two-adult, two-child family with \$20,000 income would have a standard of living similar to that of a one-adult, two-child family with \$13,700 income (the tables in the study are based on two-child families). The two-parent family that spends \$6,840 on its only child thus has roughly the same standard of living as the one-parent family that spends \$7,243 on its only child.

<sup>292</sup> One might suspect that a single parent typically would incur greater child care costs than would a married couple. Even if this were true, the difference would be reflected by the child care credit, so there would be no need for different exemption levels. Coven, note 282, at 1552-53. In fact, however, the study found that single parents below the \$32,000 income level spent slightly *less* on “child care and education” than did their married counterparts. Child Expenditures, note 149, at 16, 22.

<sup>293</sup> Child Expenditures, note 149, at 10.

<sup>294</sup> Single-parent families with three children spent 28% less on each child than those with two children. *Id.* Similarly, compared with per child expenditures of two-parent families with two children, two-parent families with one child spent 26% more on the only child, and two-parent families with three children spent 22% less per child. *Id.* at 7.

income as the family becomes larger, rather than from economies of scale in the cost of subsistence living.<sup>295</sup>

*b. Single Childless Taxpayers and the Poverty Line*

Congress made a decision in 1986 that the combination of the standard deduction and one personal exemption should not be enough to shelter the poverty level income of a single taxpayer not living with a dependent. The Senate Finance Committee offered this justification:

[T]he majority of single individuals between ages 25 and 64 live with other individuals, and thus share household costs. Thus, within the existing framework of defining the unit of tax liability, the committee believes that the poverty line is not an accurate guide to the true circumstances of the majority of those who file tax returns as unmarried individuals.<sup>296</sup>

This suggests another way of understanding the increased standard deduction for the first child of an unmarried taxpayer, which does not depend on that child's being uniquely expensive. Under this view, the difference in the standard deduction with and without a child is not so much a special benefit for the head of household, as a special detriment to the childless taxpayer. A single taxpayer not living with a dependent child is conclusively presumed to enjoy economies of scale from living with one or more other adults, whereas a single taxpayer living with a child is conclusively presumed not to enjoy any such economies.

As a factual matter, these presumptions are wildly over- and under-inclusive. But they also can be viewed as a normative judgment that childless single persons *should* live with other adults, and that single persons with children should not. The decision to live alone is treated as a personal consumption luxury, undeserving of recognition for tax purposes. I am not persuaded that living alone should be so treated, but anyone who is persuaded should find the increased standard deduction for heads of household acceptable.

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<sup>295</sup> See note 178.

<sup>296</sup> S. Rep. No. 313, note 60, at 33, reprinted in 1986-3 C.B. (vol. 3) at 33.

### C. *Child Care Allowances*

#### 1. *Allowances Based on Actual Expenditures*

##### a. *Child Care as a Business Expense*

Amounts spent by a parent for child care while the parent is at work are not deductible as business expenses.<sup>297</sup> They are, however, eligible for a credit. The child care credit is 20% (up to 30% for low income parents) of child care expenses, with a ceiling on eligible expenses of \$2,400 for one child or \$4,800 for two or more children.<sup>298</sup> The credit is unique among the major child tax allowances discussed in this Article, in that it is tied to particular expenditures on children, rather than being allowed upon the mere existence of dependent children.

Despite the consistent refusal of the courts and the Service to recognize child care costs as business expenses under § 162, the proper resolution of the business expense issue is not clear. Child care costs are caused jointly by a parent's personal and business decisions. But for the child, there would be no child care expenses; but for the parent's job, there also would be no need to pay for child care. Pure logic cannot determine whether such a jointly caused expense should be treated as business or personal. A possible general rule would be that a jointly caused expense should be treated as personal if one can imagine another taxpayer in the same business situation, but with a different personal life, who would not incur the expense. But the rule does not apply itself, and its application in this case turns on whether a childless taxpayer is the test case, or workers with children are so much the societal norm that childlessness should not be the baseline.<sup>299</sup>

The dependency exemption is based on a policy decision to treat the existence of dependent children as simply a given, rather than as a personal consumption choice.<sup>300</sup> Congress having made that decision, consistency would require that the existence of children also be accepted as a given in determining the deductibility of child care ex-

<sup>297</sup> *Smith v. Commissioner*, 40 B.T.A. 1038 (1939), *aff'd per curiam*, 113 F.2d 114 (2d Cir. 1940).

<sup>298</sup> IRC § 21. See notes 19-21 and accompanying text (describing credit in more detail).

<sup>299</sup> The other major jointly caused expense is commuting, caused by the personal decision to live in one place and to work in another. Its nondeductibility, Reg. § 1.262-1(b)(5), can be explained on the basis that another taxpayer with the same job might not incur the expense—for example, because he might live across the street from the job. The difference between applying this analysis to commuting and applying it to child care, is that the question of whether to use a taxpayer who lives close to work as the test case is much less emotionally charged than the question of whether to use a childless worker as the test case.

<sup>300</sup> See Section II.A.

penses. Treating children as a given, work-related child care costs would qualify as a deductible business expense.<sup>301</sup>

Even accepting the premise that child care expenses are a business expense, however, Congress might reasonably elect to provide for their deductibility by a special provision, rather than simply by indicating that the general business deduction provision applied. Although the cost of basic child care to enable parents to work can be reasonably viewed as a business expense, the extra cost of luxury child care is not required by work and is clearly personal.<sup>302</sup> Identification of nondeductible premium child care could be done on a case-by-case basis under the general language of § 162,<sup>303</sup> but an absolute dollar limit on the amount deductible per child (included in a special child care deduction provision) would be much easier to enforce.<sup>304</sup>

This is well illustrated by the recent Canadian Supreme Court decision in *Symes v. Canada*.<sup>305</sup> The Canadian Income Tax Act allowed a child care deduction, subject to a limit of \$2,000 per child (up to four children).<sup>306</sup> Elizabeth Symes, a lawyer with a high income, spent much more than those limits on the care of her children and attempted to deduct the entire amount under the general business expense provision. She argued her case as a matter of statutory

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<sup>301</sup> A forceful statement of this position is contained in Treasury Dep't, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* 19-20 (1985):

Child and dependent care expenses incurred in order to obtain or maintain employment affect a taxpayer's ability to pay tax in much the same manner as other ordinary business expenses. A family with \$30,000 of income and \$2,000 of employment-related child care expenses does not have greater ability to pay tax than one with \$28,000 of income and no such expenses.

...

Allowance of a deduction rather than a credit is the appropriate treatment of costs incurred in producing income.

A different argument for the deduction of child care expenses, based on the tax-free status of the imputed income of full time homemakers, is discussed at note 328.

<sup>302</sup> Brian Wolfman, *Child Care, Work, and the Federal Income Tax*, 3 *Am. J. Tax Pol'y* 153, 164-66 (1984).

<sup>303</sup> Section 162(a)(2) limits the deduction to business expenses that are "ordinary and necessary."

<sup>304</sup> When Congress has provided for deduction (or exclusion) treatment for child care expenses, it usually has imposed dollar limits on eligible expenses. This was true of the former child care deduction, enacted in 1964. Revenue Act of 1964, Pub. L. No. 88-272, § 212(a), 78 Stat. 19, 49 (codified as IRC § 214(b)(1)(B) (before repeal in 1971)). It also is true of the current exclusion under § 129 for up to \$5,000 of child care provided by an employer under a dependent care assistance program. The \$5,000 ceiling was imposed in 1986 because "Congress believed that it was inequitable to provide an unlimited exclusion to individuals whose employers provide dependent care assistance." 1986 Bluebook, note 131, at 818.

<sup>305</sup> 4 S.C.R. 695 (1993).

<sup>306</sup> Income Tax Act, note 213, § 63.

interpretation of the business expense provision,<sup>307</sup> but she also claimed that failure to allow her an unlimited deduction would violate the constitutional guarantee of equal protection.<sup>308</sup> She lost, by a vote of seven to two.<sup>309</sup> It is interesting, however, that a lower court, which had held in her favor, had found there was no question as to the reasonableness of the amount of her expenses under the statutory requirement that business expenses be reasonable in amount.<sup>310</sup> The court reached this conclusion despite the fact that in 1984 she spent \$13,173 on a nanny for one child<sup>311</sup>—more than six times the ceiling under the child care deduction. This suggests the futility of using a case-by-case approach to distinguish luxury from necessary child care.

One commentator has suggested that, in addition to a ceiling on the amount of deductible child care costs, the tax law should deny any child care deduction to high income taxpayers, on the basis that such taxpayers probably would have purchased child care even if it had not been needed to enable them to work.<sup>312</sup> This is an unappealing proposal. It is not supported by any evidence of the actual expenditures of high income taxpayers on child care not related to employment. And even if there were some general evidence, it would prove nothing about the motivation of any particular taxpayer. In other areas of the business-personal tax frontier, administrative practice permits a deduction as long as there is a *sufficient* business reason for the expense, even if the taxpayer might have incurred the expense anyway for personal reasons.<sup>313</sup> The same approach should be used here.

#### *b. A Child Care Subsidy*

The tax-internal case for a child care deduction does not preclude a child care subsidy in addition to the deduction.<sup>314</sup> One could reasonably argue for a child care deduction at all income levels and a subsidy to improve child care affordability at low (and perhaps middle) in-

<sup>307</sup> Because Canadian law generally disallows employee business expenses, her argument for unlimited deductibility applied only to the child care costs of self-employed mothers. See *id.* at § 8(2).

<sup>308</sup> See Canadian Charter of Rights and Freedoms, § 15(1), which includes an express prohibition of discrimination based on sex.

<sup>309</sup> All seven of the men on the Supreme Court were in the majority; both women dissented.

<sup>310</sup> *Symes v. Canada*, [1989] 3 F.C. 59, 75. The reasonableness requirement is imposed by Income Tax Act, note 213, § 67.

<sup>311</sup> *Symes*, [1989] 3 F.C. at 62.

<sup>312</sup> Wolfman, note 302, at 190-91.

<sup>313</sup> William A. Klein & Joseph Bankman, *Federal Income Taxation* 548 (10th ed. 1994) (discussing trips with both business and personal objectives).

<sup>314</sup> See text accompanying notes 232-38, concerning the compatibility of a dependency exemption and a general child tax credit.

comes.<sup>315</sup> There would be no reason for the amount of the subsidy to increase with income, so the subsidy should be in the form of a credit, not a deduction. It would be easy enough to combine the effect of a tax-internal deduction and a tax-external subsidy into a single child care credit, as long as the credit percentage was at least as high as the top marginal rate.<sup>316</sup> Under this approach, a 30% credit would be a tax-internal deduction equivalent for a 30% bracket taxpayer, but a deduction equivalent plus a 10% subsidy for a 20% bracket taxpayer.

Congress may have been groping toward this idea in the current child care credit. That would explain the strange combination of tax-internal and subsidy analysis in the congressional discussions of the credit.<sup>317</sup> It also would explain why the credit is available to taxpayers at even the highest income levels—a result that would make no sense if the credit were intended solely as a subsidy to make child care more affordable.<sup>318</sup> Because the current rate of credit (20% for most taxpayers) is not nearly high enough to serve as a deduction equivalent for 39.6% bracket taxpayers,<sup>319</sup> this is not a perfect explanation of current law. Nor would increasing the credit to 39.6% be a good idea—the result would be an unmerited child care subsidy for very high income taxpayers in the 31% and 36% brackets. Only separate deduction and credit provisions can grant a deduction equivalent to 39.6% bracket taxpayers without subsidizing 31% and 36% bracket taxpayers. Nevertheless, the fact that a credit can serve as the equivalent of a deduction-credit combination does illuminate some otherwise obscure aspects of the current credit.

### *c. Dollar Limits and the Number of Children*

Once the decision has been made to have a child care deduction, credit or both, the next crucial issue is the dollar limit on eligible expenses, including how the limit should vary with the number of children. Because the cost of adequate, but not luxurious, child care varies so much by situation and location, setting the limit must be

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<sup>315</sup> Low income workers with children are subsidized by the EITC, IRC § 32, but the EITC is unrelated to child care expenditures. By contrast, a child credit amounts to the government paying some specified percentage of the cost of a taxpayer's work-related child care.

<sup>316</sup> See text accompanying note 210 (discussing the use of a credit as a combination of a subsidy and a substitute for a deduction (or exemption)).

<sup>317</sup> 1976 Bluebook, note 236, at 125 ("The Congress views qualified child care expenses principally as a cost of earning income, but believes that in view of the disparity of benefits between high-income and low-income taxpayers . . . a tax credit is more appropriate.").

<sup>318</sup> See Victor Thuronyi, *Simplification for the Average Taxpayer*, 40 Tax Notes 183, 189 (July 11, 1988).

<sup>319</sup> See IRC § 1(a)-(d).



more art than science. One point, however, is indisputable. If the current limits were right when enacted in 1981,<sup>320</sup> the absence of an inflation adjustment has made them far too low today. To adjust for the change in the CPI between 1981 and 1992, the one-child limit would have to be raised from \$2,400 to \$3,706, and the two-or-more-child limit from \$4,800 to \$7,411.<sup>321</sup>

There are two possible explanations—neither of them very attractive—for the failure to adjust the dollar limit beyond the second child.<sup>322</sup> The first might be that there are infinite economies of scale in caring for more than two children—that is, child care for three or four children costs no more than child care for two. In addition to being inherently implausible, that explanation is inconsistent with the implication in the doubling of the ceiling from one to two children, that care of the second child involves no economies of scale at all. It probably does make sense to assume substantial economies of scale for child care in the home,<sup>323</sup> but the economies would be less impressive for parents using a day care center. If Congress were serious about having the dollar limits reflect economies of scale, it would have different adjustments for the number of children, depending on whether the child care was in the home or outside the home. In fact, at one time, Congress did exactly that.<sup>324</sup> But economies of scale are not a rational explanation for the current dollar limits.

<sup>320</sup> See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 124(b), 95 Stat. 172, 198 (codified as IRC § 21(c)).

<sup>321</sup> The CPI rose from 90.9 in 1981 to 140.3 in 1992. See Census Abstract, note 130, at 488 tbl. 747.

The absence of an inflation adjustment has had an equally serious—and more bizarre—effect on the phasedown of the credit from 30% to 20%. The phasedown is supposed to begin at \$10,000 AGI, with a decrease of one percentage point for every \$2,000 (or fraction thereof) by which AGI exceeds \$10,000. IRC § 21(a)(2). The problem is that, under current law, a taxpayer with a dependent child must have more than \$10,750 of AGI before having any taxable income. (Since the child care credit is nonrefundable, it is relevant only to parents with taxable income.) Even a head of household with only one child is entitled to a \$5,750 standard deduction and two \$2,500 exemptions, which would convert \$10,750 of AGI into zero taxable income. Rev. Proc. 94-72, note 8, at 3-6. If such a person has enough AGI to result in any taxable income, the child care credit will be 29% at most. Thus, the supposed 30% credit has been rendered illusory by the failure to adjust the phasedown range for inflation. Even more dramatically, a two-parent, two-child family would have no taxable income until it had AGI of more than \$16,550, making 26% its highest possible rate of credit.

<sup>322</sup> Since the creditable amount is limited by both the statutory limit and actual expenditures, it is not necessarily the case that there will be no credit for the care of a third child. If, for example, a couple spends \$1,600 on the care of each of their three children, the entire \$4,800 will be eligible for the credit.

<sup>323</sup> These economies would apply to the second child as well as to additional children.

<sup>324</sup> The Revenue Act of 1971 permitted a child care deduction of up to \$400 per month for care in the home, regardless of the number of children. The monthly limit on care outside the home was \$200 for one child, \$300 for two and \$400 for three. Pub. L. No. 92-178, § 210(a), 85 Stat. 497, 518 (codified as IRC § 214(c) (before repeal in 1976)).

The other possible explanation is that the first two children of working parents should be taken as a given, so that the cost of their care should be treated as related to the production of income, but that additional children are somehow excessive, so that the cost of their care while the parents are working should be attributed to the parents' personal consumption decision. There is nothing inherently illogical about such an attitude—society can decide to treat as a given as many or as few children as it likes. It is doubtful, however, if Congress would have the courage to put into words this attitude toward working parents with more than two young children. The attitude also is inconsistent with the dependency exemption, which treats every additional child as a given, no matter how large the family. In any event, this is a strange place for Congress to be so stingy. The revenue cost of greater generosity to larger families should not be great; working parents paying for child care for three or more children are not that common.

## 2. *Allowances not Based on Actual Expenditures*

There have been a number of proposals in recent years for universal tax allowances for parents of preschoolers, regardless of whether the parents work outside the home and incur child care expenses. Some proposals would allow parents to choose between the current expenditure-based child care credit and a new credit based on the mere existence of a young child in the home.<sup>325</sup> Other proposals would replace the existing credit with a credit (or increased exemption) not based on expenditures, thus making actual child care costs irrelevant in all cases.<sup>326</sup>

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<sup>325</sup> In 1989, President Bush proposed giving low income taxpayers a choice between the existing child care credit and a new credit not based on expenditures. Staff of the House Comm. on Ways and Means, 101st Cong., 1st Sess., Background Material and Data on Programs Within the Jurisdiction of the Committee on Ways and Means 1273-75 (Comm. Print 1989) [hereinafter Background Material]. The proposed credit would have been available for every dependent child under the age of four. The amount of the credit for each child would have been the lesser of \$1,000 or 14% of parental earned income. The proposal called for phaseout of the credit between \$15,000 and \$20,000 earned income. The new credit would have been in addition to the existing EITC.

Another proposal, made by Rep. Wolf in 1991, would have required parents to choose between a "supplemental young child credit" and the child care credit. For each child under the age of five, the parents would have been entitled to a credit of the lesser of \$500 or 5% of earned income. Phaseout of the credit would have been between \$50,000 and \$60,000 AGI. See H.R. 2633, 102d Cong., 1st Sess. 2-3 (1991). The Canadian income tax includes a provision of this type. Parents who claim no deductible child care expenses for a child under seven are entitled to a special credit (\$213 in 1993). Income Tax Act, note 213, § 122.2; Kesselman, *Child Tax Benefit*, note 213, at 112.

<sup>326</sup> The Family Research Council has proposed repealing the current child care credit and replacing it with a special \$600 credit for young children. Reclaiming the Tax Code,

Some advocates of these proposals argue they are necessary to remedy the bias in the existing child care credit against full time parents, who are not eligible for the credit because they incur no expenses. "[C]razy as it may seem," claims Gary L. Bauer, "the tax code penalizes parents for spending time with their children by narrowly linking certain tax benefits to day care expenses."<sup>327</sup> The problem with this argument is that it ignores the offsetting tax benefit full time parents receive from not being taxed on the imputed income produced by their child care services.<sup>328</sup> Taking that benefit into account, the tax treatments of employed and homemaking parents are roughly comparable. At low income levels, homemakers are disfavored because the exclusion of their imputed income operates in the 15% bracket, whereas the credit for paid child care is 20% or more. This is more than offset, however, by the fact that the \$4,800 ceiling on expenses eligible for the credit does not apply to the exclusion of imputed income.

A different argument for a credit not based on expenditures would acknowledge that such a credit results in a net bias in favor of full time homemakers—they receive one benefit in the form of the credit and another in the form of the imputed income exclusion, whereas employed parents receive only the credit. The argument would view that favoritism as appropriate, however, because of the superiority of parental child care over the purchased variety.<sup>329</sup> But this argument has its own problems. First, the proposition that the government should

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note 35, at 59. This is part of a larger proposal to replace the dependency exemption with a \$1,200 credit. Parents of a young child thus would be entitled to a total credit of \$1,800.

The Progressive Policy Institute has made a similar proposal, involving a special exemption rather than a credit. Kamarck & Galston, note 39, at 22-26. Under this proposal, the dependency exemption for children under age four would be increased to \$6,000, with the increase phased out "at some point near double median income." *Id.* at 24. The proposal is rather vague about the repeal of the current child care credit, but it does note that the increased exemption "would allow the federal government to do away with all day care expenditures and tax credits that are not targeted specifically to poor children or to children with special needs (such as the handicapped or the mentally retarded)." *Id.*

<sup>327</sup> Bauer Statement, note 35, at 54.

<sup>328</sup> Some commentators have argued that parents who pay for child care must be allowed a child care deduction to give them a tax benefit equivalent to the exclusion of imputed income from child care. As Brian Wolfman has explained, the tax disparity between those who purchase services and those who perform the same services for themselves is not sufficient reason to allow a deduction for the purchased services. Wolfman, note 302, at 178-81. If it were, almost every personal expense—washing the car, cleaning the house, mowing the lawn—would have to be deductible, and the tax base would virtually disappear. To justify a deduction, there must be a reason that a tax disparity between purchased and self-performed services of a particular type is undesirable. In the case of child care, the argument would be that differing income tax treatments should not influence mothers' decisions to seek employment or remain home. *Id.*

<sup>329</sup> A related argument is that full time homemakers feel undervalued by society, and that a child care credit available to them would constitute important validation of their

encourage mothers of young children to stay home is controversial. It can be seen as an attempt to further the best interests of children, but it also can be seen as an attempt to keep women "in their place." Second, a much cheaper way to influence mothers' decisions would be to repeal the child care credit, resulting in a tax bias in favor of staying home caused by the imputed income exclusion.

A more appealing argument for a universal young child tax credit is based not on the idea of encouraging mothers to make a particular choice, but on the idea of empowering mothers to make either choice. If a mother wants to work, the credit would help make purchased child care affordable; if the mother wants to stay home, the credit would help compensate for the loss of earned income. In other words, the purpose would be to ease the financial burden on parents of young children, however they choose to handle child care.<sup>330</sup> The credit still results in a net tax bias in favor of staying home, but under this analysis that is a side effect, rather than the point of the provision. An important implication of the analysis is that the credit should not be available to high income parents. If one parent has a high income, the other parent already is empowered financially either to stay home with the children or to work outside the home and pay for child care; neither decision involves a financial burden worthy of governmental relief.<sup>331</sup>

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worth. Consider the following statement of Heidi Brennan, Co-executive Director of Mothers at Home, in support of a universal young child credit:

The first priority of a family is to care for itself. By penalizing its efforts through excessive taxation, we not only ignore the value and necessity of that work, but we suggest that the unpaid labor of nurturing is beneath our national dignity. We suggest that only income, which can be taxed, is a pursuit worthy of political and social recognition.

Reclaiming the Tax Code, note 35, at 77.

This is not a model of logical analysis. It seems to say that homemakers would feel more respected if the government did them the favor of taxing their imputed income. Nevertheless, the feeling of not being appreciated comes through clearly enough.

<sup>330</sup> The idea that there is a special financial burden on parents of young children seems inconsistent with the substantial evidence that children become more expensive—both in terms of subsistence needs and in terms of typical above-subsistence expenditures—as they grow older. See text accompanying notes 137 (subsistence) and 185-87 (above subsistence). A proponent of a special tax benefit for parents of young children might respond in two ways. First, the studies that show children becoming more expensive with age consider only the cash cost of children. They do not consider forgone earnings, which are the major cost of being a full-time parent during a child's early years. Second, the studies tend to understate the cost of purchased child care for parents who must purchase it; the average cost is distorted by the many parents who perform their own child care, or receive it free from friends or relatives. Edward J. McCaffery, *Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code*, 40 *UCLA L. Rev.* 983, 1021 n.149 (1993).

<sup>331</sup> Different proposals for young child tax allowances have taken different positions on this issue. The Bush proposal would have phased out the young child credit at fairly low incomes. See Background Material, note 325, at 1273-75. The Family Research Council proposal would not have phased out the credit at any income level. Reclaiming the Tax

## VI. CONCLUSION

As I remarked at the outset, my main purpose in this Article is not to set forth my own views on how the tax laws should take into account differences in family responsibilities, but to illuminate the theoretical foundations and practical consequences of the possible approaches. I have not, however, resisted the temptation to offer my own opinions. Despite the popularity of child tax credits (or some other form of family allowances) in other countries, I believe there is a very strong tax-internal case for the use of a dependency exemption. A continuing exemption based on the cost of subsistence appropriately reflects differences in ability to pay due to differences in family size, at all income levels. The precisely correct level of the exemption is debatable, but the current level is clearly too low. The tax-internal case for formula income splitting is considerably weaker, depending as it does on a benefit principle that is not a well established part of the income tax tradition in this country.

I am skeptical of proposals for child tax credits to achieve tax-external goals. The goals may be worthy, but a tax credit is not likely to be an effective means of achieving them. In any event, the adoption of a credit as a subsidy does not destroy the tax-internal case for an exemption, so proposals to *replace* the exemption with a credit are not attractive to one who favors—as I do—the clear income analysis. Unlike a tax-internal exemption, which should be available at all income levels, a tax-external credit should be completely phased out at some income level;<sup>332</sup> there is no good reason for subsidizing the child-rearing costs of the affluent.

The special status conferred on the first child of an unmarried parent by the head of household rules makes no sense and should be eliminated. The EITC should be redesigned to confer additional benefits on larger families, by continuing to increase the credit percentage for children beyond the second. The child care credit should be converted to a deduction; that would not preclude a credit subsidy for lower income parents, in addition to the deduction.

More important than these specifics, however, is the idea that politicians and interest groups should examine more carefully the rationales of the various proposals for increased tax benefits for families. Considering the number of recent proposals, some sort of tax relief for

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Code, note 35, at 59. The strangest proposal is that of the Progressive Policy Institute, Kamarck & Galston, note 39, at 22-26, which calls for a phaseout, thus seeming to recognize that the allowance is a subsidy for low and middle income parents. Yet, it calls for putting the allowance in the form of an increased exemption, resulting in upside-down subsidy effects before the phaseout begins.

<sup>332</sup> To the extent the credit is intended to serve as a substitute for an exemption, it is not a tax-external provision and should not be phased out. See text accompanying note 222.

families is likely to be enacted in the next few years. Families deserve better tax treatment than they currently receive, but some ways of improving their treatment make more sense than others. I hope the form of relief chosen enables Congress to explain it as something more than a decision to throw money at an important group of voters.